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IN THE

Supreme Court of the United States

OCTOBER TERM, 1961

No. 570

ALBERT GORDON MACRAE and SHEILA MACRAE,

Petitioners,

—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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—v.—

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

The petitioners pray that a writ of certiorari issue to review judgments of the United States Court of Appeals for the Ninth Circuit, entered in the above-entitled case.

Opinions Below

The findings of fact and opinion of the Tax Court (R. 26) are officially reported (see 34 T.C. 20). The opinion of the Court of Appeals for the Ninth Circuit is not yet officially reported. Both opinions are reprinted in the Appendix hereto.

Jurisdiction

The judgment of the Court of Appeals was entered on August 28, 1961. The jurisdiction of this Court is invoked under 28 U.S.C. Section 1254.

Statutes Involved

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.

Statement of Facts

The facts material to this petition may be summarized as follows:

The petitioners, husband and wife, filed joint returns on the cash basis for the taxable years 1952 and 1953. The transactions at issue herein were transactions of the petitioner husband and he is referred to hereinafter as the petitioner. The petitioner is a well-known entertainer. His business and financial matters were handled for him by his attorneys (R. 27).

In December of 1952 B. Gerald Cantor, president of Cantor, Fitzgerald & Co., Inc. (hereinafter called "C-F"), brokers and dealers in securities, discussed with the petitioner's attorneys the possibility that some of the latter's clients might purchase United States Treasury Notes with a small down payment, using borrowed funds for the bulk of the purchase price. Shortly thereafter, one of the peti-

tioner's attorneys advised him that he could purchase one million dollars in Treasury notes primarily with borrowed money, and that the interest on the loan would be a "good tax deduction." The petitioner was further advised that a profit reportable as a capital gain was possible, and that the loan could be made on a nonrecourse basis (R. 27-28).

Petitioner expected to realize a tax saving through the transactions. He also understood that there might be a profit apart from taxes (R. 65, 93).

On December 19, 1952, with settlement date of December 26, petitioner placed with C-F an order to purchase for his account 1⅜ per cent Treasury notes, maturing March 15, 1954, in the face amount of one million dollars. The confirmation slip of C-F showed the price as $992,500, with accrued interest of $3,874.31. Thereupon the petitioner issued a check in the amount of $3,874.31, which C-F received on or about December 26, 1952. Petitioner also executed and delivered to C-F his promissory note in the amount of $992,500, dated December 26, 1952 and due March 15, 1954, with interest at 2½ per cent per annum. The taxpayer's note was without personal liability and was limited to the collateral security, consisting of the Treasury notes. It provided that petitioner might sell the Treasury notes at any time and discharge the indebtedness by payment of the net proceeds received. He might also anticipate payment by paying additional interest of ½ per cent per annum prorated to the maturity date of March 15, 1954. The note further recited that petitioner had paid the interest, due and to be due, concurrently with the execution of the note and gave C-F a lien against the securities pledged for the principal amount of the note. C-F was to have the right to "rehypothecate or borrow the said securities, provided however, that such rehypothecation or borrowing shall not be inconsistent in any manner with the ownership"

by the petitioner of the securities. The petitioner was to have the right "to obtain the return of said securities in kind at any time upon tender of payment of the principal indebtedness due" under the note (R. 28-29).

C-F purchased $2,000,000 in such Treasury Notes from C. F. Childs, a dealer in such securities, which amount included the $1,000,000 of Notes ordered by petitioner. Subsequently on the same day, C-F sold $2,000,000 of the same Treasury Notes which it had purchased for petitioner. The sales were made for C-F's own account (R. 177). C-F gave petitioner no notice of its sales of the securities and he did not know at any time that C-F intended to make such sales or that it had made them, and, perforce, he gave no order for such sale (R. 82, 91-92).

C-F borrowed petitioner's securities to make delivery against its sale. The "borrowing" of securities is a regular practice among dealers and brokers in securities (R. 29-30).

On December 26, 1952, the taxpayer issued to C-F a check in the amount of $30,257.42, as interest to March 15, 1954 (R. 30).

On or about January 26, 1953, petitioner's loan owing to C-F was refinanced through Gibraltar Financial Corporation (hereinafter called "Gibraltar") of New York City. C-F arranged for this refinancing (R. 101). Petitioner executed a new note under which Gibraltar was substituted for C-F as payee, the nonrecourse feature was eliminated, the interest rate was reduced from 2.5 per cent to 2.42 per cent, the amount of the "loan" was increased from $992,500 to $1,020,000 (face value of the Notes plus interest coupons), and the right to a refund of a portion of interest upon prepayment was eliminated (Exh. 7).

On the same day, petitioner issued his check to C-F, as correspondent for Gibraltar, in the amount of $27,930.11,

as interest to March 15, 1954, on the new note. At the same time, he received a check from C-F in the amount of $28,082.08 as refund of interest on cancellation of the old note (R. 17).

Under the terms of the new note, the $1 million in Notes was pledged as collateral security. In accordance with this arrangement, petitioner directed C-F to deliver the Notes to Gibraltar against payment of $1,020,000. Gibraltar was a correspondent for C-F in New York City. Dealings between such correspondents are reflected in Omnibus accounts (or reciprocal accounts). In accordance with the customary practice in such case, C-F's obligation to deliver the $1,000,000 of petitioner's Notes to Gibraltar was properly recorded in the respective accounts, with the reciprocal obligations of the two firms being balanced off (R. 141, 166-167).

On August 12, 1953, petitioner directed C-F to sell the foregoing $1,000,000 face value of Notes. C-F effected a sale in due course and confirmed the sale of such notes at a total price of $1,001,891.98, including accrued interest in the amount of $5,561.98 (Exh. 25-4). Petitioner authorized C-F to receive the Notes from Gibraltar against payment, and on the same day instructed Gibraltar to deliver the Notes to C-F against payment (Exhs. 11, 18).

In order to comply with petitioner's order to deliver against payment, Gibraltar purchased for its own account $1,000,000 face value of United States Treasury 1⅜ per cent notes due March 15, 1954 and directed the delivery of such notes to the Chemical Bank & Trust Company (hereinafter called "Chemical") as clearance agent for C-F against payment of $1,001,891.98 (R. 191-2, Exh. 11). Petitioner did not direct the purchase of such Notes by Gibraltar and was not aware that Gibraltar had made such purchase. Petitioners reported in their income tax return for

the year 1953 a long term capital gain in the amount of $3,125.00 arising from the sale of the $1,000,000 U. S. Treasury 1⅜% notes (Exh. 2).

Petitioner made further purchases of securities in 1953, as follows:

On March 10, with settlement date of March 11, petitioner ordered C-F to purchase for his account $2 million face amount 1¾ per cent Federal Land Bank Bonds (hereinafter called "Bonds"), due October 1, 1955-1957, and to deliver them to Gibraltar against payment of $1,925,555.56, the price of C-F's purchase (Exh. 25-1). Thereupon, petitioner executed and delivered to Gibraltar his full-recourse promissory note in the amount of $2,104,000, bearing interest at the rate of 4¼ per cent per annum, payable October 1, 1955, and renewable to October 1, 1957, with interest at the rate of 2¼ per cent per annum for any such extended period (Exh. 8).

The note recited that petitioner had pledged the Bonds with Gibraltar as collateral security, and that $178,444.44 of the principal amount of the note would be withheld as security for interest, to be released as interest payments were made. Prepayment to September 1, 1955, was permitted at the rate of 1½ per cent from date of prepayment to maturity.

Gibraltar obtained the $1,925,555.56 which it paid out against these Bonds hypothecated by petitioner by selling equivalent bonds short for its own account and on its own initiative, and delivering petitioner's bonds against its sale (R. 162-163, 191-192). Neither petitioner nor his attorney had directed any such short sale by Gibraltar and neither was aware that any short sale was contemplated by Gibraltar in handling the loan or that any was made (R. 82, 91-92).

On August 12, 1953, petitioner directed the sale of these Bonds and such sale was confirmed by C-F to petitioner at a total amount of $996,250, plus accrued interest. Petitioner directed Gibraltar to deliver the bonds to C-F against payment of the amount owed to it (Exh. 11), and Gibraltar purchased equivalent bonds in the open market for its own account and directed delivery to the clearance agent for C-F against payment. Petitioner had not directed such purchase by Gibraltar and was not aware of it (R. 82, 91-92, 191-193).

On August 13, 1953, and October 30, 1953, petitioner entered into essentially similar transactions involving $1 million face amount U. S. Treasury Notes 1¾% due December 15, 1955, and $1 million face amount U. S. Treasury Notes 1½% due April 1, 1958, respectively (Exhs. 25-1, 25-2). Petitioner executed and delivered to Gibraltar full-recourse notes similar to that covering the Bond transaction, in the respective principal amounts of $1,043,250 with interest at 2⅞% and an interest reserve of $54,178.96 and $107,067,000 with interest at 2¾% and an interest reserve of $94,554.95 (Exhs. 9, 10). Subsequent to the taxable years in issue petitioner closed out these transactions by directing the sale of the Notes and such sale and delivery were effected in essentially the same manner and circumstances as in the case of the 1⅝% Notes and the Bonds.

During 1953, petitioner issued checks in the net amount of $132,632.12 to Gibraltar representing interest due on its notes (Exh. 3, R. 16-17).

During 1953, petitioner received various amounts from C-F, both on its own and on Gibraltar's account, representing interest accrued and due on the various Notes and Bonds which he had purchased and which he owned. Petitioner reported $34,094.82 in his 1953 return as interest income (R. 17).

Petitioner intended to purchase the United States Government obligations, above described, and to borrow the various amounts evidenced by his notes given to C-F and Gibraltar in order to pay the bulk of the purchase price of the securities so purchased. He gave the orders to purchase the securities and signed the aforesaid notes solely with such intention to purchase securities and to remain the owner thereof until he sold them, notwithstanding the hypothecation of the securities to secure the said loans. The notes which he gave to the lenders state that petitioner was entitled "to obtain the return of said securities in kind at any time upon tender of payment of the principal indebtedness due" under the note (R. 28-29).

Questions Presented

1. Is it proper, in applying Section 23(b), 1939 I.R.C., to indebtedness incurred in transactions of a commercial nature, as distinguished from transactions of a purely personal nature, to deny deduction of interest paid on such indebtedness merely because the transaction may have provided no "reasonable" chance of profit apart from the tax consequences, or merely because the taxpayer's sole, or main, motive in entering the transactions may have been tax reduction?

2. In applying Section 23(b), 1939 I.RC., is it proper to consider the effect of Section 117, 1939 I.R.C., relating to the taxation of capital gains and losses, on the overall transaction which gave rise to the indebtedness; or must the interest deduction (Section 23(b), 1939 I.R.C.) be allowed as long as real, enforceable indebtedness has been created, without regard to the tax consequences of the transaction as a whole?

3. May a taxpayer who is one party to a contract be held responsible for the independent acts of the other party, which are not required by the terms of the contract, expressly or by implication, and of which the taxpayer had no knowledge? Specifically, where a taxpayer buys securities and pledges same for a purchase money loan and the lender sells the same type of securities short for its own account, borrowing the taxpayer's securities to make delivery, may such short sales be attributed to the taxpayer-borrower so as to negative his continuing ownership of the securities and the indebtedness based thereon, even though the short sale was not required or contemplated by the terms of the contract and the borrower had no knowledge of the lender's purpose to make a short sale or of the fact of the sale?

4. Were the provisions of Section 23(b), 1939 I.R.C. correctly applied in this case?

Reasons for Granting the Writ

Preliminary Statement

Two bases of decision appear in the Tax Court's opinion in this case, to which the Court of Appeals gave blanket approval.

First, the Tax Court found petitioner's transactions had an "essential nullity", apparently because the lender, with which petitioner hypothecated securities for purchase-money loans, sold equivalent securities short and borrowed petitioner's securities to make delivery against its sale, thereby providing the lender with funds to finance the loans to petitioner.

Second, the Tax Court concluded petitioner's loans were not "indebtedness" within Section 23(b), but were "shams"

because petitioner purported to enter into the transactions as "hard-headed commercial transactions for profit", yet "no reasonable chance existed of realizing a profit" apart from the tax consequences.

Petitioner believes these two conclusions reflect errors of law and involve direct conflicts with decisions by other Courts of Appeal and of this Court; also, that the instant decision involves important questions of Federal tax law which have not been but should be settled by this Court.

These errors are patent in the findings and opinion of the Tax Court. For one, the Tax Court ascribed the lenders' short sales to petitioner although it found, generally, that "dealers and brokers will hold securities as collateral and when necessary, borrow securities so held to cover short sales"; also, and more particularly, that petitioners "had no actual knowledge of the mechanics of the transaction as undertaken by (the lenders)."

Second, the Tax Court inconsistently held the transactions herein were "shams" under Section 23(b) because no reasonable opportunity for profit existed, while agreeing that the unqualified word "indebtedness" in Section 23(b) embraces personal debts incurred without profit motive or opportunity.

The errors of the decision in this case are brought into focus when the Tax Court's approach and rationale in this case are compared with that in another similar case decided by it five days earlier. The inconsistency of the Court's rationale in the two cases, each concerned with the meaning of "indebtedness" as used in Section 23(b), can only be construed as indicating that the instant case has not been decided with due regard to controlling principles of law.

I. The instant decision creates a conflict among the Courts of Appeal as to whether a profit motive or opportunity is a necessary condition to the allowance of the interest deduction under Section 23(b), 1939 I.R.C.

The Tax Court made a vital determination of law in this case, with blanket approval by the Court of Appeals, which is in conflict with prior holdings of the Court of Appeals for the Second Circuit and with the plain meaning of governing Section 23(b), 1939 I.R.C. This determination of law is confused in an ostensible finding of fact—that petitioner's transactions were "sham"—but its true character and its lack of validity are unmistakable.

The petitioner, Gordon MacRae, testified candidly at the hearing that a substantial reason for entering into the transactions at issue was to effect a tax saving, although he also hoped to (and had a chance to) realize a profit apart from taxes. Petitioner argued in his briefs below that as long as the indebtedness created by petitioner was bona fide, interest paid thereon is deductible under Section 23(b); that his motive in entering into the transactions which gave rise to the indebtedness is immaterial since no business or profit motive is required under the terms of Section 23(b). Thus, interest on indebtedness to buy a family residence or to take a vacation, etc., etc., has always been recognized as being deductible.

Addressing itself to this crucial contention by petitioner, the Tax Court stated at the end of its opinion:

> "Had petitioners in fact borrowed money for a vacation, or for any other purely personal purpose, they would clearly be entitled to a deduction for any interest paid on such loan, and we do not understand respondent to contend otherwise. We must first, how-

ever, determine whether petitioners in fact incurred a bona fide indebtedness regardless of their reasons for doing so. We are forced to conclude in the light of the entire record that they did not.

"Petitioners did not purport to borrow funds for personal reasons, but rather in respect of hard-headed commercial transactions for profit. They acted within the formal framework of such premise, and it is in the light of the nature of the transactions as claimed by them that we must determine the reality or lack of it in what they did.

"Petitioners have purported to enter into a profit-seeking transaction. Yet under the circumstances, no reasonable chance existed of realizing a profit, apart from the 'tax gimmick' feature of the transactions the very aspect in which they were originally presented to and found acceptable by petitioners. *It is for this reason* that we conclude that the transactions in question, the reality of which may be sustained only on the theory that they were commercial undertakings for profit, were shams, and must be disregarded for tax purposes. Accordingly, respondent's determination is here sustained. Cf. L. Lee Stanton, 34 T.C. —— (filed April 7, 1960)." (Emphasis added.)

Manifestly, this statement differs from the usual determination of "sham" in tax cases, which signifies that a transaction is other than it purports to be purely as a matter of fact—that it pretends to be what it is not. Here, the Tax Court is labelling the transaction a "sham" not because it is other than it purports to be, but rather because the transaction does not, as a matter of law, qualify under the requirements of Section 23(b), 1939 I.R.C., as the Tax Court interprets that Section.

In essence, the Tax Court has held this: The word "indebtedness" as used in Section 23(b) encompasses money obligations incurred for personal, non-profit, purposes such as for a "fly now pay later" vacation. But if an indebtedness is incurred in a "commercial transaction," it does not qualify if no reasonable chance existed of realizing a profit" apart from the tax consequences. "*It is for this reason*", the Court stated bluntly, that the transactions in question "• • • were shams and must be disregarded for tax purposes." (Emphasis added.)

This is not a factual determination that the transactions at issue were other than the purchases of securities and the borrowing of the purchase price that they purported to be. It is, rather, a naked conclusion of law that the borrowing does not qualify as "indebtedness" under Section 23(b) because petitioner entered into the transaction of purchasing securities without any reasonable chance of profit apart from the effect of tax law on the transaction; in other words, because petitioner entered into the transactions solely or mainly to minimize his taxes.

This determination of law has far-reaching implications with respect to the application of Section 23(b) (as well as its exact counterpart, Section 163, 1954 I.R.C.). It is clearly erroneous, and the decision based thereon, as fully approved by the Court of Appeals for the Ninth Circuit, is in direct conflict with the decision of the Court of Appeals for the Second Circuit in *Kraft Foods Co.* v. *Commissioner*, 232 F. 2d 118, revg. 21 T.C. 513, which held that valid indebtedness qualifies under Section 23(b) even though the sole or principal purpose of creating the indebtedness was tax minimization, without any commercial purpose. This issue, which has never been decided by this Court, is the crux of the instant case.

In interpreting a word in a statute, it is manifestly improper to give it one meaning in one case and the opposite meaning in another. Yet that is what the Tax Court has done here, in effect, in recognizing that "indebtedness" in Section 23(b) embraces personal debts lacking both profit motive and profit opportunity and at the same time holding that petitioner's indebtedness was "sham" because the transactions from which it arose provided no reasonable expectation of profit. Congress did not create two separate classifications of indebtedness in Section 23(b) with different tests applicable to each. It used only the single unqualified word "indebtedness" as a test and if "indebtedness" is construed to mean that profit motive is not necessary in some kinds of transactions, that is what it must mean in respect of all transactions.

Thus, it is wholly immaterial under Section 23(b) that "petitioners have purported to enter into a profit-seeking transaction." All that is material is whether petitioner entered into real, enforceable transactions of purchasing securities and borrowing money to pay the purchase price. When Congress intended to include a profit test in a deduction provision, it said so explicitly, as in Section 23(e), 1939 I.R.C., referring to losses incurred in "transactions entered into for profit," etc. It included no similar test in Section 23(b) and the premise upon which the Tax Court sought to label petitioner's transactions as sham, namely, that petitioner "purported to enter into a profit transaction", is, thus, false and irrelevant to the application of Section 23(b).

Even granting, *arguendo*, the Tax Court's postulate that "it is in the light of the nature of the transactions"—i.e., as "hard-headed commercial transactions for profit"—"that we must determine the reality or lack of it" in petitioner's transactions, and granting, *arguendo*, that there

may be transactions which create enforceable legal rights as between the parties thereto yet may not be real for the purpose of Section 23(b), the question posed by this case is this:

> May *reality* for the purpose of Section 23(b) be defined so as to exclude from its purview, indebtedness incurred at arm's length terms in transactions such as the petitioner herein consummated, involving the purchase of negotiable securities issued by the government of the United States on the regularly constituted market therefor, through a regularly established broker which is a member of the National Association of Securities Dealers and subject to regulation and supervision by that body and by the Securities and Exchange Commission?

This describes a normal transaction entered into daily by thousands of American citizens through brokers and banks which is surely of the very essence of reality and is recognized as such by the respondent for the purpose of Section 23(b) and otherwise. It also describes petitioner's transactions within the postulate of the Tax Court. It is *only* on the Tax Court's finding that this petitioner, in exercising his legal right to purchase the securities at issue and to borrow money at a normal rate of interest to pay the purchase price, had "no reasonable chance of profit" apart from the *normal tax consequences* (which the Court labels a "tax gimmick")—it is expressly *on that ground alone*—that the Court calls petitioner's transactions "shams".

That, petitioner submits, is not a finding of lack of reality in petitioner's transactions as such, but a determination of law that those real transactions do not qualify under Section 23(b), as the Court interprets that provision, *only*

because it finds "no reasonable chance of profit • • •." This determination is in direct conflict with the decision of the Court of Appeals for the Second Circuit in the *Kraft Foods Company* case, supra.

In the *Kraft Foods Co.* case, supra, the taxpayer corporation issued $30,000,000 in its debentures to its parent corporation in payment of a dividend declared out of surplus. It thereby expected to obtain a deduction for the interest paid on the indebtedness, to replace the credit for dividends paid to its parent, the right to which Congress had repealed a short time before. In denying deduction of the interest paid on these debentures, the Commissioner argued that transactions "though formally perfect and in compliance with a provision of the tax statute must be disregarded if they have no purpose germane to the conduct of the business other than tax minimization."

Rejecting the Commissioner's argument, the Court of Appeals noted that it is established that, "transactions even though real, may be disregarded if they are a sham or a masquerade • • •," but: "The inquiry is not what the purpose of the taxpayer is, but whether what is claimed to be is in fact • • •." Pointing out, further, that the taxpayer and its parent corporation had engaged in certain objective acts with the intent of creating legal rights and duties and that the occurrence of these acts affected their legal relations, the Court allowed the deduction of the interest paid by the taxpayer in accordance with its legal obligation.

In the instant case, petitioner directed the purchase of securities, and this was in fact done on the open market. Petitioner became the owner of the securities and he borrowed the purchase price. Under the principle of the *Kraft Foods* case, this was sufficient to create "indebtedness" within Section 23(b), irrespective of petitioner's mo-

tive to make a profit or to minimize taxes. It was sufficient if the transactions themselves created the intended legal rights with whatever opportunity for profit legal ownership entailed under the circumstances. However, the instant case holds, in essence, that petitioner's transactions do not qualify, irrespective of the valid legal rights and obligations created thereby, because petitioner entered into commercial transactions for profit, without having any reasonable chance of profit—i.e., solely for the purpose of tax minimization. This case is, thus, in direct conflict with *Kraft Foods Co., Inc.* v. *Commissioner*, supra.

This case is also in essential conflict with a decision by the Court of Appeals for the Second Circuit, holding that interest on personal indebtedness is deductible under Section 23(b).

> *William P. T. Preston* v. *Commissioner*, C.A. 2, 132 F. 2d 63, rev'g 44 B.T.A. 973.

The main question thus presented to this Court is this:

> In applying Section 23(b) to indebtedness incurred in transactions of a commercial nature, as distinguished from transactions of a purely personal nature, is it proper to deny deduction of interest paid on such indebtedness merely because the transactions may have provided no "reasonable" chance of profit apart from the tax consequences—or merely because the taxpayer's sole or main motive in entering the transactions was tax reduction?

A corollary question, which is implicit in the Tax Court's approach in this case, is this:

> In applying Section 23(b), is it proper to consider the effect on the transaction of Section 117, relating to the taxation of capital gains and losses, or must the

interest deduction be allowed as long as real, enforceable indebtedness has been created, without regard to the tax consequences of the transaction as a whole?

Restatement of a few basic facts of the case will put these questions into proper perspective. Petitioner purchased early maturity obligations of the United States yielding approximately 1½ per cent interest per annum. To carry these securities, he borrowed money at 2½ per cent per annum. Just prior to maturity, approximately 15 months after he purchased the securities, petitioner sold the securities, realizing a profit which he reported as a capital gain. The natural possibility had existed that the price of the securities which he purchased would rise, due to a decline in interest rates or other economic factors, in due time to give petitioner a profit apart from taxes. If this did not eventuate, petitioner was advised, and he believed, that he would profit in so far as his excess interest cost (over yield realized) would reduce income subject to high surtax rates and his ultimate profit on sale of the securities would be subject only to a 25 per cent capital gains tax.

It is manifestly this translation of the excess interest cost into a net profit through the operation of the capital gains tax which has caused the denial of the interest deduction in this case. Obviously, when the Tax Court weighed petitioner's chance of realizing a profit in applying Section 23(b), it was tacitly considering Section 23(b) not as an independent provision of the Code allowing the deduction of interest on (real) "indebtedness", but as if Section 117 imposed a limitation on Section 23(b). But no such limitation appears in Section 117 or in Section 23(b), as is the case in other instances where Congress intended one provision to act as a limitation on another—as in Section 23 (a)(1)(B) or in Section 23(p)(1), each expressing a different limitation on Section 23(a)(1)(A).

Moreover, profit expectation is too subjective to serve as a valid test. A novice might anticipate a profit in a situation from which an expert would shrink—and yet the novice could prove to be the real "expert" in the end. With uncertainty an inevitable factor, reasonableness of profit expectation is a treacherous as well as irrelevant basis to determine whether the interest deduction is allowable, inviting the application of hindsight in determining reasonableness. This may already have been demonstrated, in the case of *L. Lee Stanton*, 34 T.C. 1 (Appendix, page 64), as will appear.

This profit test creates an inevitable threat to potential purchasers of obligations issued by the United States, particularly in view of the uncertainty which it entails, and it, therefore, constitutes a real deterrent to the marketability of such securities which could conceivably affect the fiscal operations of the United States Treasury.

The problem is not confined to cases like this one, financed by the lender through a short sale, but touches the entire area of government bond dealings on credit. This is readily apparent in the case of *L. Lee Stanton, supra*. There, the taxpayer purchased $5,000,000 face value of United States Treasury Notes bearing 1½ per cent interest coupons for $4,921,968.75 (plus accrued interest of $21,644.01) during June and July 1953. Stanton borrowed the full face value of the notes, or approximately $78,000 in excess of their market value from four different banks on his own 3½ per cent term promissory notes, prepaying interest of $151,830.77. Stanton sold the notes for a total of $5,021,187.50 in February, 1954 (plus accrued interest of $25,570.08), after experiencing some difficulty in persuading certain of the banks to accept prepayment of his loans. The Commissioner disputed Stanton's right to deduct the interest paid on this indebtedness.

The Tax Court upheld Stanton, allowing deduction of the interest paid on his indebtedness to the banks. The Commissioner did not appeal the *Stanton* case. It is significant, however, that he is continuing to contest like cases involving the hypothecation of United States obligations by high-bracket taxpayers at banks. See *Clifford E. Hood, et ux.*, T.C. Memo, No. 1961-231.

Thus, manifestly, the fiscal and tax problems posed by the instant case have not been set at rest—including the inevitable deterrent to purchases of United States obligations. Rather, the Commissioner's actions in the *Stanton* and *Hood* cases suggest that such a deterrent may suit the Commissioner's ends only too well. To date he has not acquiesced in the *Stanton* case. This, together with his failure to appeal that case and his pursuit of other taxpayers in like position, can only continue the existing confusion and uncertainty as to the meaning of the law.

The issue in this case was not resolved by this Court's decision in *Knetsch* v. *Commissioner* (1960), 364 U.S. 361. That case did not involve the purchase of property, such as is present here. The essence of the decision in the *Knetsch* case, supra, is that what purported to be an insurance contract of $8,388,000, on its face actually amounted to a commitment of $1,000 due to the taxpayer's own annual borrowing of the full amounts available under the policies. Accordingly, this Court ruled that Knetsch's transaction did " 'not appreciably affect his beneficial interest except to reduce his tax * * * ' ".

In the instant case, petitioner directed the purchase of securities which had a fixed market value, and became obligated to pay the purchase price. Petitioner undertook the full risk of ownership of the securities and *his* beneficial interest was affected to the full extent of their cost.

The particular questions in this case are, thus, outside the scope of the *Knetsch* case. The Court of Appeals appears to have recognized that in the instant case. Although its decision refers to the *Knetsch* case, it was merely by reference its decision in *Kaye* v. *Commissioner*, 287 F. 2d 40. Petitioner can detect no intimation of any reliance on *Knetsch* in the Court of Appeals' decision in the instant case.

II. The instant decision creates a conflict with applicable decisions of this Court and of the Courts of Appeal respecting the question whether a motive to minimize taxes invalidates an otherwise valid transaction.

In stressing the taxpayer's motive, however obliquely, rather than the reality of what the taxpayer did, the instant decision is in conflict with a long line of decisions by this Court and the Courts of Appeal holding that the motive to reduce or minimize taxes does not invalidate otherwise legitimate transactions for the tax purposes.

> *Gregory* v. *Helvering*, 293 U.S. 465, 469;
> *Chisholm* v. *Commissioner*, C.A. 2, 79 F. 2d 14, 15;
> *Sawtell* v. *Commissioner*, C.A. 1, 82 F. 2d 221, 222;
> *Commissioner* v. *Veiser*, C.A. 6, 75 F. 2d 956, 958;
> See also *Kraft Foods Co.* v. *Commissioner*, *supra*, 127, 128, and cases therein cited.

That the motive to avoid taxes is not sufficient to invalidate an otherwise real transaction for tax purposes has been settled beyond any doubt. This has most recently been demonstrated in cases which have allowed a purchaser of bonds the right to amortize the premium on the bonds although the bonds are donated to charity shortly after

their purchase, even though this entails a double deduction of the premium (by way of amortization deduction).

Maysteel Products, Inc. v. *Commissioner*, C.A. 7, 287 F. 2d 426;
Fabreeka Prods. Co. v. *Commissioner*, C.A. 1, —— F. 2d ——, Oct. 5, 1961;
T. M. Evans, et al. v. *Dudley*, C. A. 3, —— F. 2d ——, Nov. 8, 1961.

III. The Tax Court has introduced inconsistencies into its decisions on this issue which indicate a failure to apply pertinent principles of law to petitioner's case. Adoption of the Tax Court's rationale in this case by the Court of Appeals raises two important issues which have not been, but should be, settled by this Court.

A. The Tax Court's inconsistency in applying a profit test under Section 23(b), 1939 I.R.C., as approved by the Court of Appeals in the instant case, places that test in the posture of an issue never passed upon but requiring consideration by this Court.

That the Tax Court upheld Mr. Stanton's right to deduct the interest which he paid to the banks while denying the same right to petitioner five days later on substantially similar facts necessitates a comparison of the two cases. Such a comparison reveals two significant focal points: (a) the application of the profit test, and (b) the respective lenders' methods of financing the loans.

As to the profit element, it must be noted that Lee Stanton did not realize a pre-tax profit from his transactions any more than the petitioner herein did. Such a profit was actually possible for Stanton at one point, but several of the banks refused to refund any of the prepaid interest at that time.

In contrast with its position in the instant case, the Tax Court, in the *Stanton* case, could find no profit requirement in Section 23(b):

> "• • • Congress has included no requirement in the Code that the borrowed money be used in connection with a transaction entered into for profit or that it cannot be borrowed for personal or nonbusiness purposes or used in a transaction involving tax benefit • • •".

The Court found that the clear and convincing legislative history of Section 23(b) supported this position.

At another point, the Tax Court had this to say in *Stanton*:

> "The Internal Revenue Code imposed heavy taxes on Lee and he sought a legal way within the provisions of the Code to make a profit for himself *after taxes*, the only kind of profit which can do any taxpayer any good." (Emphasis added.)

Noting further, that Stanton "had reasons, which seemed sufficient to him at the time" to believe the banks would accept prepayment of the loans, the Court concluded:

> "What reason is there for penalizing Lee and deviating from the plain words of the Internal Revenue Code merely because the unexpected action of the banks wiped out Lee's real gain by requiring him to pay about $126,000 of additional interest?"

Thus has the Tax Court, in a single paragraph, (a) avowed that profit before taxes is not essential under Section 23(b), and, (b) hastened to emphasize that Stanton did have an actual profit (if only the banks had waived $126,000 of interest to which they had a valid right at law).

Thus too, within a period of five days, has the Tax Court (in a reviewed decision joined by 12 of the 16 judges) ruled in the *Stanton* case that a profit before taxes is not essential under Section 23(b) and then in the instant case, that petitioner's transactions were "sham" because "no reasonable chance existed of realizing a profit apart from the 'tax gimmick' feature of the transactions * * *."

No less incompatible with its holding in the instant case is the weight given by the Tax Court to the fact that Stanton might have had (but actually did not have) a pre-tax profit. The test laid down in the instant case was "chance" of profit. No mention was made of that test in *Stanton*. This is an interesting disparity. For, while the Court concluded that the petitioner herein had no reasonable expectation of profit, the facts demonstrate that he had at least twice the expectation of profit, objectively viewed, that Stanton could have had. Whereas petitioner paid 2½ per cent interest on his borrowing, Stanton paid 3½ per cent. Thus, Stanton had approximately double the excess interest cost (over the approximately 1½ per cent yield of the bonds) to overcome before he could realize a pre-tax profit that petitioner had!

The fact that Stanton could have realized a pre-tax profit in these circumstances simply demonstrates that such an opportunity existed for petitioner as well, since petitioner purchased the same type of bonds as Stanton, under more favorable terms.

This inconsistency of rationale reflected in the two cases can leave only doubt that the Tax Court has been able to decide the issue by reference to appropriate and valid principles. What effect an *actual* profit test for the interest deduction, such as the Court appears to have entertained in the *Stanton* case, would have on the securities markets,

with their large quotient of credit transactions, can only be left to the imagination. How many people would be anxious to buy United States Government bonds and notes if they knew in advance that the interest paid on borrowing for the purchase would not be tax-deductible unless an actual profit was made?

An actual profit test is manifestly untenable, but where would Stanton be if the same test of profit expectation, or "chance", had been applied to him as was applied to the petitioner herein?

The blanket approval of the Tax Court's decision by the Court of Appeals in this case sanctions the inconsistency of the Tax Court's rationale and holding herein. It raises an important question—whether profit is a proper factor for consideration in applying Section 23(b), and if so, on what basis. This question is fundamental in the application of the Internal Revenue laws. It has not been but should be settled by this Court.

B. The Tax Court's inconsistency (approved by the Court of Appeals) in attributing the independent lender's short sale to the petitioner (borrower), absent collusion in such sales on the part of petitioner, poses an unsettled issue which should be considered by this Court.

There is one difference in the facts of the instant case and those in *Stanton* which gives rise to another substantial question. That concerns the lenders' resort to the short sale in the instant case. Stanton hypothecated the bonds with banks and there was no evidence whether the banks retained the bonds, rehypothecated them with the Federal Reserve Banks at full face value (as proved in the instant case) or effected short sales. The Commissioner argued in the *Stanton* case that it was controlled by such cases as *Eli D. Goodstein* (1958) 30 T.C. 1178, aff'd per curiam (C.A.

1, 1959) 267 F. 2d 127 etc., in which the lenders had financed through the medium of short sales. Rejecting the Commissioner's contention and distinguishing the *Stanton* case, the Tax Court stated:

> "• • • • The alleged *Goodstein* transactions were *collusive* shams throughout arranged by Eli Livingstone. The Treasury notes were purchased and sold practically as one transaction in which no real money passed on behalf of the taxpayer. • • • " (Emphasis added.)

Petitioner submits that the key word in the foregoing quotation is "collusive". That word is warranted by the facts of the *Goodstein* and the other cases which followed it, all of which were arranged by Eli Livingstone. It is not warranted on the facts and findings of the instant case. Therefore, the instant case is distinguishable from *Goodstein* etc., but cannot be distinguished from *Stanton*, and it is in fact inconsistent with the holding in *Stanton*.

The lender-borrower relationship, *per se*, is ordinarily that of independent contractors; one party lends his money as a principal to the borrower who is likewise a principal to the transaction. However, the facts developed in the *Goodstein* and other cases handled by Mr. Livingstone, a securities dealer in Boston, permitted the inference that such was not the relationship in those cases. The facts show that his customers were informed from the outset how Livingstone expected to handle the transactions. A private ruling by the Internal Revenue Service, which Mr. Livingstone exhibited to his customers as part of his particular sales "pitch", described every aspect of the transactions, including the lender's borrowing of the hypothecated securities. The inference of collusion in a mere "tax gimmick" which necessarily stemmed from the tax-

payer's knowledge of what Livingstone proposed to do was reinforced by the fact that the parties did not behave like ordinary customer and broker effecting a bona fide purchase of securities on margin. Rather, their actions suggest that their only intent was to join in the creation of a facade for tax purposes. In the *Goodstein* case, for example, no amount was credited to the taxpayer's account by the lender on account of interest earned on the Treasury bonds and no interest was reported as income by the taxpayer Goodstein. Nor was any sale of Treasury securities made by the taxpayer when he decided to close out his transactions; only bookkeeping entries were made on the lender's books closing out the account. These facts compel the inference that the parties never intended that Goodstein own any bonds or incur any indebtedness predicated on such ownership, but only that a mere facade be established for tax purposes. Similarly, in the *Lynch* case, 31 T.C. 990, aff'd C.A. 2, 273 F. 2d 867, it appears that no bonds were ever purchased on the market, but only book entries were set up showing an ostensible ownership of bonds. The inference of collusion to create a mere facade of ownership was irresistible in the circumstances.

In the instant case, the government conceded that the form of petitioner's transactions, unlike that in the *Goodstein* case and the *Sonnabend* case (T.C. Memo. 1958—178, aff'd C.A. 1, 267 F. 2d 319), etc., was flawless. No discrepancies appear in the course of dealing in purchasing bonds, borrowing, sale of bonds and repayment.

The Tax Court recognized this "greater perfection of form", but it professed to see no difference in substance. Noting that the results in prior cases such as *Goodstein*, etc., were obtained because the substance of each of the respective transactions differed from its form, the Court concluded that "petitioners here are not aided because this divergence is even greater in their case."

Petitioner maintains that the impeccable form of his transactions while not, in itself, a basis for granting the rights he claims, is simply corroborative proof that he intended to purchase and own the United States Government securities which were actually purchased in his behalf. Surely, petitioner had the same right as any other citizen to purchase such securities on credit. That is what he intended to do, and did, following his attorneys' advice to buy the particular securities and borrow money to pay the purchase price, on the attractive terms which were available, in order to achieve the desired tax saving, because petitioner had everything to gain by performing this simple, practical, action—and nothing to lose; the risk-free character of the securities he purchased, and the unquestionable credit of the United States, insulated him from loss. The impeccable form of petitioner's transactions reflects this simple truth. What he did is merely what everyone does, day in and day out, when they intend to purchase securities on margin, or credit, through a broker. Petitioner did not deal with Livingstone. He was not in privity with Goodstein, Sonnabend, or any other customer of Livingstone. Their patent shams cannot abridge his right to consummate real transactions.

One salient error by the Tax Court is the key to its view of petitioner's case. At one point in the opinion the Court asserts that, "The various purchases and sales, each real without the other, neutralize one another." The inference is plain that the Court meant to attribute the lenders' short sales to the petitioner.

What basis is there for such an action in *this* case? Petitioner dealt with a broker, situated and doing a general securities business with the public in Beverly Hills, California, 3000 miles removed from Mr. Livingstone's headquarters in Boston. The record plainly reveals that this

broker apparently understood that the desired tax consequences depended upon real transactions. Every party to petitioner's transactions took the stand at the hearing in this case (unlike the various "Livingstone cases") and testified, subject to cross-examination, that neither the petitioner nor his representatives were ever advised about the short sale procedure. Petitioner laid great stress on this fact in his briefs before the lower courts, as he does here. With full understanding of the significance which petitioner attached to this point, Judge Forrester, who presided at the hearing of this case, found:

> "Petitioners urge that they had no actual knowledge of the mechanics of the transactions as undertaken by C-F and Gibraltar (the two lenders in this case), *and we believe this to be true.*" (Emphasis added.)

Judge Forrester went on to say that this point had been disposed of in the *Goodstein* case, *supra*. That conclusion is without basis. Goodstein did not claim that he did not know of the mechanics of the transaction, nor could he have claimed this since he had read the ruling which described the short sale procedure in detail. (In fact, he sought unsuccessfully to establish an estoppel on the basis of the ruling.) As the very language quoted by Judge Forrester from the *Goodstein* case shows, Goodstein "testified that he did not give an order for the sale of the Treasury notes, and that he did not know of the sale at the time it occurred."

This is substantively different from petitioner's position, as proved and as found by the Tax Court. The facts respecting the display of the Revenue Ruling and the failure to carry out real transactions of purchase, borrowing and sale of securities in the *Goodstein* case fully warranted the inference that the transactions therein were *collusive*, the basis upon which Judge Murdock expressly distinguished the *Stanton* case from *Goodstein*, etc. Having authorized

the creation of a mere facade, a nullity, it was immaterial that Goodstein did not specifically "give an order for the sale of the Treasury notes," and "that he did not know of the sale at the time it occurred." It was clearly sufficient in law that the acts were performed in accordance with his over-all collusive arrangement.

The proof and the Court's finding in the instant case that petitioner "had no actual knowledge of the mechanics of the transaction" preclude any finding of collusion on the part of petitioner. Indeed, the Court's assertion that petitioner's transactions were a "nullity" because of the lenders' short sales hardly seems consistent with its subsequent conclusion that the transactions were (merely) "shams" only because "no reasonable chance of profit existed" apart from tax consequences.

The important question thus presented by the instant case, for which no precedent appears in Federal tax annals, is this:

> Where a taxpayer buys securities and pledges same for a purchase money loan and the lender sells the same type of securities short for its own account, borrowing the taxpayer's securities to make delivery, may such short sales be attributed to the taxpayer-borrower so as to negative both his continuing ownership of the securities and his indebtedness, even though the short sale was not required or contemplated by the terms of the contract and the borrower had no knowledge either of the lender's purpose to make a short sale or of the fact of his making the short sale?

In general terms:

> May a taxpayer who is a party to a contract be held responsible for the independent acts of the other party, which are not required by the terms of the contract,

expressly or by implication, and of which the taxpayer did not even have knowledge?

The question is important because the result of the decision in the instant case is to put every purchaser of stocks, or other securities on margin on notice that his ownership and the rights incident thereto may be terminated by the independent actions of the broker-pledgee in borrowing his stock.

Petitioner's note authorized the lender to "rehypothecate or borrow the said securities". As unimpeachably proved by petitioner, it is the universal practice in the financial community for brokers and other lenders to reserve the right to rehypothecate or borrow customers' securities held by them on margin. Brokers regularly borrow their customers' margin securities to lend to other customers who may be short such securities, for their own account or to lend to other brokers for their own or their customers' account. In the face of this universal practice, the Commissioner has never been known, heretofore, to claim that the borrowing of a customer's securities by his broker terminates the customer's ownership so that he would have to report a gain or loss at that point, or so that his holding period would end for capital gain purposes.

Petitioner's position is no different. In granting the lender the right to borrow his securities, petitioner did only what all taxpayers are required to do in the same circumstances. The lender could have borrowed petitioner's securities for a variety of purposes, such as for loan to other customers of the lender, or to other brokers for loan to their customers. Nor did anything in the contract require the lender, expressly or by implication, to borrow the securities. It could have rehypothecated the securities, as banks themselves do regularly. The granting of the right to the lender

to borrow the securities, thus, could not have put the petitioner on notice that the lender would sell the same type of securities short in order to carry out its obligations under the loan contract.

The fact that petitioner's motive in entering the transaction may have been mainly or wholly to effect a tax saving does not warrant an inference of collusion or sham. Yet, on the record of this case, that is the effect of the Tax Court's decision.

As the holding in the *Stanton* case shows, it was possible to achieve the tax saving by buying the securities and borrowing the money. That is all petitioner sought to do and that is all that he did do, insofar as any actions which are attributable to him at law are concerned.

It should be noted that the lenders did not have to tell petitioner or his representatives about the short sale. Since the securities at issue were debt obligations, and not equity securities, the lender's risk as a short seller was limited by the $1,000 face value of the securities. (Such securities occasionally rise a small fraction above their face value, but no more.) The lenders did not require the collusion of the petitioner in order to carry out the transaction according to their own designs.

Thus, the Tax Court's finding that petitioner had no knowledge of the lenders' short sales is unavoidable on the record, although the conclusion of law which the Tax Court drew from this fact is erroneous.

As a matter of procedure, petitioner maintains that the Tax Court erred in admitting into evidence, over petitioner's objections, proof that the lenders had sold short for their own account the same type and amount of securities which petitioner had hypothecated with said lenders for the purchase money loans made to him. The short sales

were the independent transactions of the lender and, as such, can have no significance with respect to petitioner's rights. This was substantial error in so far as the Tax Court expressly concluded that such sales rendered the purchases of securities by the petitioner a "nullity."

Fred C. Niederkrome et al. v. *Commissioner*, C.A. 9, 266 F. 2d 238.

No basis appears in the record for admitting such extraneous evidence as an element of respondent's case against this petitioner and, in view of the Tax Court's finding that petitioner did not even know of the short sales, no such basis exists.

The decision by the Court of Appeals herein failed to correct the demonstrated errors of the Tax Court's rationale and holding on this point.

IV. The blunt inconsistencies and contradictions in approach and rationale as between the instant case and the *Stanton* case, supra, demonstrated in Point III, hereof leave the unavoidable inference that the Courts have decided the instant case with such disregard of controlling principles of law as to call for this Court's exercise of its power of supervision.

The inconsistencies and contradictions of the Tax Court's approach and rationale, as demonstrated in Point III, hereof, indicate plainly that the Tax Court and the Court of Appeals have decided the instant case in disregard of controlling principles of law.

No other conclusion is rational when, only five days apart, the Tax Court finds petitioner's transactions were "sham" because "no reasonable chance existed of realizing a profit apart from the 'tax gimmick' feature," and in

another case involving the same issue (*Stanton*), holds that "Congress has included no requirement in the Code that the borrowed money be used in connection with a transaction entered into for profit • • • or that it cannot be used in a transaction involving tax benefits • • • " and deemed it meaningful to state that Stanton had "sought a legal way within the provisions of the Code to make a profit for himself *after taxes, the only kind of profit* which can do any taxpayer any good." (Emphasis added.)

And the foreseeability test applied in the instant case—i.e., "reasonable chance" of profit—contrasts oddly with the hindsight test used in *Stanton* where the taxpayer had but half the chance of profit at the outset that petitioner had.

Nor were these inconsistencies impeded by the fact that the Tax Court was compelled, in *Stanton*, to renounce the rationale advanced by it in four earlier cases. (The revised rationale advanced for these cases, that there was no real indebtedness, only *collusive* shams, has no application to the instant case where collusion has been negatived.) Taking into account the findings of the instant case, the only valid conclusion is that petitioner's right to buy United States government obligations on credit, like any other citizen, is being abridged because the Tax Court and the Court of Appeals deem it unfair, or unpatriotic, to allow petitioner the exceptional tax benefit to which he is entitled under the law as written by Congress.

As was so aptly stated in the *Fabrecka Prods.* case, supra: "Granted the Government's proposition that these taxpayers have found a hole in the dike, we believe it one that calls for the application of the Congressional thumb, not the Court's".

The Court of Appeals' decision not only endorses the Tax Court's errors, but it is irregular on its own account

in that it ignores the Tax Court's finding that petitioner did not know about the mechanics of the transaction. Rejecting petitioner's contention that since neither he nor any representative of his was apprised by the lenders of the short sale procedure and that there was no collusion in such sale, the sale could not be treated as his, the Court quoted from the opinion of the Court of Appeals, Second Circuit, in *Lynch* v. *Commissioner*, supra, at 872, as follows:

> "Save in those instances where the statute itself turns on intent, a matter so real as taxation must depend on objective realities, not on the varying subjective beliefs of individual taxpayers. Beyond this, it would strain credulity to the breaking point to suppose that taxpayers had no inkling that something highly unusual was going on."

The foregoing quotation may have been apt in a case like *Lynch*, where the evidence permitted no reasonable inference but that the transactions were collusive. For example, no securities were ever purchased for the taxpayer in *Lynch;* the purchases and ownership of securities existed on paper only. In any other context, the Court's reference to "objective realities overriding the taxpayer's intent" must be untenable to the point of pure absurdity. Borrower and lender are independent contractors. To impute the "objective realities" of what one does, in his independent capacity, to the other, is fuzzy thinking, tantamount to saying that when one person buys property, another person sells it to him and as an "objective reality" nothing of legal significance has occurred because the sale neutralizes the purchase.

As for the point in the *Lynch* case concerning the taxpayer's knowledge, there was no finding in that case, as there was in the instant case, that the taxpayer did not

know about the mechanics of the transaction. This finding is wholly warranted by the evidence in the instant case and was binding on the appellate court. The petitioner herein was in no way in privity with Mr. Lynch and what the latter may have done or known cannot abridge this petitioner's rights to buy securities, to borrow the purchase money and to deduct interest paid on his purchase money indebtedness. Moreover, the *Stanton* case, with its parallel borrowings from five different banks, shows that what may have strained the Court of Appeals' credulity is really quite ordinary and usual. The risk-free quality of the securities, virtually the equivalent of dollars, dictated the terms of the transaction and underwrites their legitimacy. The terms were carried out in scrupulous detail.

On the record, petitioner may not be treated differently than any other purchaser of government securities, say Stanton, no matter how great or how unusual is the benefit petitioner may derive under the law. That he has been, is due to a series of plain inconsistencies and contradictions, and such a disregard of controlling principles, as to call for the exercise of this Court's power of supervision.

CONCLUSION

For the foregoing reasons this petition should be granted.

November 22, 1961.

Respectfully submitted,

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APPENDIX

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

No. 17128

ALBERT GORDON MACRAE and SHEILA MACRAE,

Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Judgment

Upon petition to review a decision of the Tax Court of the United States

This cause came on to be heard on the Transcript of Record from the Tax Court of the United States and was duly submitted

On consideration whereof, it is now here ordered and adjudged by this court that the petition to review is granted to the limited extent of remanding the case to the Tax Court for a redetermination of deficiency for the taxable year 1953, in the light of the opinion of this court.

(Endorsed) Judgment
Filed and Entered August 28, 1961

FRANK H. SCHMID, *Clerk*

Opinion in *Gordon MacRae and Sheila MacRae* v. *Commissioner*. *Albert Gordon MacRae and Sheila MacRae* v. *Commissioner*

TAX COURT OF THE UNITED STATES

Docket Nos. 61091, 67789. 34 TC —, No. 2.
Filed April 12, 1960.

Bernard Speisman, Esq., and Jerald S. Schutzbank, Esq., for the petitioners. Mark Townsend, Esq., and Michael P. McLeod, Esq., for the respondent.

FORRESTER, *Judge*: Respondent has determined deficiencies and an addition in the income tax of petitioners for the calendar years 1952 and 1953 as follows:

Year	*Deficiency*	*Addition Sec. 294(d)(2)*
1952	$ 23,998.38	
1953	109,768.42	$6,172.19

Petitioners raise no separate contentions with respect to the addition for 1953; consequently, the sole issue remaining is the deductibility of certain purported interest payments.

FINDINGS OF FACT

The stipulated facts are so found.

At all times material petitioners have been husband and wife residing in Beverly Hills, California. Their joint income tax returns for the calendar years 1952 and 1953 were filed on the cash basis with the director of internal revenue at Los Angeles. Gordon MacRae, also known as Albert Gordon MacRae, will be referred to as the petitioner.

Petitioner is a well-known entertainer. Prior to the years in question he had made no substantial investments in securities. His business and financial matters were handled for him by his attorneys.

B. Gerald Cantor has at all times material been president of Cantor, Fitzgerald & Co. (hereinafter called "C-F"), brokers and dealers in securities. In December of 1952, Cantor and petitioner's attorneys discussed the possibility that some of the latters' clients might purchase substantial face amounts of United States Treasury Notes (hereinafter called "Notes") with a minimal down payment, using borrowed funds for the bulk of the purchase price.

Shortly thereafter, one of petitioner's attorneys advised him that he could purchase $1 million in Notes primarily with borrowed money, and that the interest on the loan would be a "good tax deduction." Petitioner was further advised that a profit reportable as a capital gain was possible, and that the loan could be made on a nonrecourse basis.

Petitioner did not seek further details. He did not know nor did he inquire as to the interest rate required on the loan, the rate of return on the Notes, or the possibility of profit or loss on the entire transaction apart from tax considerations. His principal purpose in agreeing thereto was the creation of a deduction for tax purposes.

On December 19, 1952, with settlement date of December 26, petitioner placed with C-F an order to purchase for his account 1⅜ per cent Notes, maturing March 15, 1954, in the face amount of $1 million. The confirmation slip of C-F showed the price as $992,500, with accrued interest of $3,874.31. Thereupon, petitioner (1) issued a check

in the amount of $3,874.31, which C-F received on or about December 26, 1952, and (2) executed and delivered to C-F his promissory note in the amount of $992,500, dated December 26, 1952, and due March 15, 1954, with interest at 2½ per cent per annum.

Petitioner's note was without personal liability. It was limited to the collateral security, consisting of the Notes. It provided that petitioner might sell the Notes at any time, and discharge the indebtedness by payment of the net proceeds received. He might also anticipate payment by paying additional interest of ½ per cent per annum prorated to the maturity date of March 15, 1954. The note contained the following provision:

> "The undersigned has paid the interest, due and to be due hereunder, concurrently with the execution hereof, and hereby gives obligee a lien against the securities pledged for the principal amount of the indebtedness set forth herein, and obligee may re-hypothecate or borrow the said securities, provided, however, that such re-hypothecation or borrowing shall not be inconsistent in any manner with the ownership by the undersigned of said securities. Undersigned shall have the right to obtain the return of said securities in kind at any time upon tender of payment of the principal indebtedness due hereunder."

When petitioner placed his above order with C-F, the latter had no Notes in inventory. On December 26, 1952, C-F went through the mechanics of both buying and selling $2 million in such Notes, which amount included the $1 million ordered by petitioner. At the close of business on

December 26, 1952, C-F's inventory did not include any Notes.

The transaction whereby C-F bought and sold the Notes was as follows: C-F arranged a purchase from and sale to C. F. Childs (hereinafter called "Childs"), a dealer in securities, to be effected the same day. Carl M. Loeb, Rhoades & Co., Inc. (hereinafter called "Rhoades") acted as clearance agent. Pursuant to instructions from C-F, Rhoades received the Notes against payment to Childs, and on the same day redelivered them to Childs against payment from the latter. C-F was charged a clearance fee and any differential between the purchase and sale prices.

The sale to Childs constituted a "borrowing" by C-F of the Notes in accordance with the above quoted provision of petitioner's note, a common practice among dealers and brokers in securities.

On December 26, 1952, petitioner issued to C-F a check in the amount of $30,257.42, purportedly as interest to March 15, 1954.

The Gibraltar Financial Corporation (hereinafter called "Gibraltar") was incorporated on or about December 24, 1952. Initial working capital consisted of $1,500 in borrowed money and $2,000 of capital investment paid in on December 29, 1952. No further capital was invested in Gibraltar at any time pertinent.

For the period December 24 to December 31, 1952, Gibraltar's records reflect loans to customers in the amount of $17 million, with another $17 million in such loans for the following month. The first such loan, in the amount of $1,020,000, is recorded as being made December 26, 1952. All "loans" listed on Gibraltar's books during the period

here in issue arose through transactions similar to those of petitioner, as hereinafter described.

Gibraltar's balance sheet was as follows on the dates shown below:

THE GIBRALTAR FINANCIAL CORPORATION

BALANCE SHEET

ASSETS	*December 24, 1952 (Date of Incorporation)*	*December 1, 1953*
Cash in Banks	$2,000.00	$ 23,913.88
Notes and Accounts Receivable		126,609,919.61
Securities Owned—		
Long		20,158.68
Other Assets		1,084.53
	$2,000.00	$126,655,076.70
LIABILITIES		
Accounts Payable		$ 15,706.75
Accrued Expenses—		
Taxes		17,058.42
Securities Borrowed		126,623,456.20
Capital Stock	$2,000.00	2,000.00
Deficit		(3,144.67)
	$2,000.00	$126,655,076.70

On or about January 26, 1953, petitioner's purported loan owing to C-F was refinanced through Gibraltar, petitioner executing a new note. Under its terms, Gibraltar was substituted for C-F as payee, the nonrecourse feature was eliminated, the interest rate was reduced from 2.5 per cent to 2.42 per cent, the amount of the "loan" was increased from $992,500 to $1,020,000 (face value of the Notes plus interest coupons), and the right to a refund of a portion of interest upon prepayment was eliminated.

On the same day, petitioner issued his check to C-F, as correspondent for Gibraltar, in the amount of $27,930.11, purportedly as interest to March 15, 1954, on the new note. At the same time, he received a check from C-F in the amount of $28,082.08, as refund of interest on cancellation of the old note.

Under the terms of the new note, the $1 million in Notes was pledged as collateral security. In accordance with this arrangement, petitioner directed C-F to deliver the Notes to Gibraltar against payment of $1,020,000. C-F did not then have the Notes, and the transfer of the Notes and liability was accomplished by book entries of C-F and Gibraltar.

On August 12, 1953, petitioner purported to sell the Notes to C-F at a total price of $1,001,891.98, including accrued interest in the amount of $5,641.98. He authorized C-F to receive the Notes from Gibraltar against payment, and on the same day instructed Gibraltar to deliver the Notes to C-F against payment.

Pursuant to petitioner's instructions, Gibraltar placed an order with Guaranty Trust Company of New York (hereinafter called "Guaranty") dated August 12 with settlement date of August 13, 1953, for $1 million in Notes at

a total purchase price, including accrued interest, in the amount of $1,002,204.48, to be delivered to Irving Trust Company (hereinafter called "Irving") as clearance agent. At the same time, Gibraltar instructed Irving to receive the Notes from Guaranty against payment of $1,002,204.48, and to deliver $1 million in Notes to the Chemical Bank & Trust Company (hereinafter called "Chemical") as clearance agent for C-F against payment of $1,001,891.98.

At the same time as it agreed to purchase $1 million in Notes from petitioner, C-F also arranged to sell the Notes to Chemical in two lots of $500,000 each. C-F instructed Chemical as clearance agent to receive $1 million in Notes from Irving, which was acting as Gibraltar's clearance agent, against payment of $1,001,891.98, and to deliver the same amount in Notes to the bond department of Chemical against payment of $1,002,126.36.

As a result of the foregoing, Gibraltar and C-F were charged by their respective clearance agents with the clearance fee and the difference between the buy and sell prices. The only substantial monies or credit utilized belonged to the clearance agents, whose willingness to use their funds or credit was attributable to the fact that they had instructions to deliver as well as to receive against payment, and that, apart from the comparatively nominal clearance fee and difference between buy and sell prices, no risk existed.

On March 10, 1953, petitioner entered into a transaction as follows:

On March 10, with settlement date of March 11, petitioner ordered C-F to purchase for his account $2 million face amount 1¾ per cent Federal Land Bank Bonds (hereinafter called "Bonds") due October 1, 1955-1957, and to deliver them to Gibraltar against payment of $1,925,555.56,

the price of C-F's purchase. Thereupon, petitioner executed and delivered to Gibraltar his full-recourse promissory note in the amount of $2,104,000, bearing interest at the rate of 4¼ per cent per annum, payable October 1, 1955, and renewable to October 1, 1957, with interest at the rate of 2¼ per cent per annum for any such extended period.

The note recited that petitioner had pledged the Bonds with Gibraltar as collateral security, and that $178,444.44 of the principal amount of the note would be withheld as security for interest, to be released as interest payments were made. Prepayment to September 1, 1955, was permitted at the rate of 1½ per cent from date of prepayment to maturity.

On March 10, 1953, C-F arranged a purchase of $2 million face amount of Bonds from Childs with settlement date of March 11, at a price of $1,924,305.56, and instructed Chemical as clearance agent to receive the Bonds against payment. On the same day, C-F instructed Chemical to deliver the Bonds against payment in the amount of $1,925,555.56 to Irving as clearance agent for Gibraltar. In turn, Gibraltar instructed Irving to receive the Bonds from Chemical against payment of $1,925,555.56 and to deliver them on the same day to Childs against payment of $1,923,680.56.

As a result of the foregoing, C-F and Gibraltar were charged clearance fees and the difference between the respective buy and sell prices. Two million dollars face amount of Bonds were bought from and sold to Childs on the same day, and neither C-F nor Gibraltar ever actually received possession thereof.

On August 13, 1953, and October 30, 1953, petitioner entered into essentially similar transactions involving $1 million face amount U. S. Treasury Notes 1¾ per cent due

December 15, 1955, and $1 million face amount U. S. Treasury Notes 1½ per cent due April 1, 1958, respectively. Petitioner executed and delivered to Gibraltar full-recourse notes similar to that covering the Bond transaction, in the respective principal amounts of $1,043,250 with interest at 2⅞ per cent and an interest reserve of $54,178.96, and $1,067,000 with interest at 2¾ per cent and an interest reserve of $94,554.95. Subsequent to the taxable years in issue petitioner closed out these transactions as well as that respecting the Bonds in essentially the same manner as already described with respect to the Notes.

During 1952 and 1953, petitioner issued checks to C-F, purportedly as interest payments, as follows:

Checks issued by petitioner, Gordon MacRae, during the years 1952 and 1953 to Cantor, Fitzgerald & Co., Inc., and deducted in the 1952 and 1953 income tax returns.

Date	Check Number	Total Amount	ALLEGED LOANS DATED Dec. 26, 1952	Jan. 26, 1953	Mar. 11, 1953	Aug. 13, 1953	Oct. 30, 1953	Miscellaneous
1952								
Dec. 26	2079	$ 30,257.42	$ 30,257.42					
Total Claimed in Return		$ 30,257.42	$ 30,257.42					
1953								
Jan. 26	2259	$ 27,930.11		$27,930.11				
26	Refund	(28,082.08)	(28,082.08)					
Mar. 9	2396	11,599.77			$ 11,599.77			
June 4	2735	11,599.77			11,599.77			
Aug. 12	3034	28,474.29				$28,474.29		
12	Refund	(14,285.34)		(14,285.34)				
26	3079	11,599.77			11,599.77			
Dec. 4	3420	11,599.77			11,599.77			
17	3464	69,598.62			69,598.62			
23	3491	2,631.43					$2,631.43	
Miscellaneous Adjustment		(33.99)						$(33.99)
Total Claimed in Return		$132,632.12	$ (28,082.08)	$13,644.77	$113,397.70	$28,474.29	$2,631.43	$ (33.99)

The first check, in the amount of $30,257.42, dated December 26, 1952, was received by C-F for its own account. The remaining checks were received for the account of Gibraltar.

In 1953 petitioner received various amounts from C-F, both on its own and on Gibraltar's account, purportedly as interest, a refund of interest, the balance due on a sale of notes, and a refund of excess loan funds.

Petitioner reported $34,094.82 in his 1953 return as interest income, and $1,562.50 as 50 per cent of capital gain upon sale of the Notes.

The original note of petitioner dated December 26, 1952, was without recourse because petitioner was concerned over a note of such size. Thereafter his legal and business advisers were able to assure him that in reality no risk existed, and all later notes were with recourse. This recourse feature permitted a slightly lower rate of interest, but its principal purpose was to strengthen petitioner's legal position in the event the deductibility of purported interest payments should be challenged.

Gibraltar did not at any time have possession of any Notes or Bonds, and consequently did not receive interest thereon. Its books do not reflect such interest receipts, but do credit petitioner with the amount of interest which he would have received as a holder.

Petitioner at no material time intended to borrow money from C-F or Gibraltar, or to purchase securities with their assistance. Nor did C-F or Gibraltar ever intend to lend any amount to petitioner. The intent and purpose of all parties concerned was the creation of a deduction for tax purposes, through a transaction which in form would ap-

pear to create an indebtedness but which in fact was lacking in substance.

OPINION

After careful review of the foregoing facts, we find the instant proceeding indistinguishable in principle from *Eli D. Goodstein*, 30 T. C. 1178 [Dec. 23,152], affd. 267 F. 2d 127 (C. A. 1) [59-1 USTC ¶ 9474]. Cf., also, *Knetsch* v. *United States*, 272 F. 2d 200 (C. A. 9) [59-2 USTC ¶ 9767], certiorari granted February 23, 1960; *Danny Kaye*, 33 T. C. — (filed December 16, 1959) [Dec. 23,891], on appeal (C. A. 9); *George G. Lynch*, 31 T. C. 990 [Dec. 23,456], affd. 273 F. 2d 867 (C. A. 2) [60-1 USTC ¶ 9161]; *W. Stuart Emmons*, 31 T. C. 26 [Dec. 23,201], affd. sub nom. *Weller* v. *Commissioner*, 270 F. 2d 294 (C. A. 3) [59-2 USTC ¶ 9667]; *Broome* v. *United States*, 170 F. Supp. 613 (Ct. Cl., March 4, 1959) [59-1 USTC ¶ 9290]; *Haggard* v. *United States*, an unreported case (D. Ariz., February 17, 1959) [59-1 USTC ¶ 9299].

To be sure, formal appearances have been given more artistic attention in the instant case than in any prior proceeding, and petitioners rely heavily on this greater perfection of form. We discern no difference in substance, however. The results in the cited cases were obtained because the substance of each of the respective transactions differed from its form; petitioners here are not aided because this divergence is even greater in their case.

Petitioners may prevail only if the payments in question were in fact and in substance interest, i.e., consideration paid for the use or forbearance of money. Cf. *Deputy* v. *DuPont*, 308 U. S. 488 [40-1 USTC ¶ 9161]. The only money used here belonged to the banks acting as clearance agents.

These funds were used for a short period (less than 1 day), and the banks were paid in full therefor, when they received their clearance fees. Gibraltar, the alleged recipient of most of the so-called interest payments, had no money, and neither it nor C-F forebore or permitted the use thereof, as a result of the "financial round robins" in which the parties engaged. Cf. *Broome* v. *United States*, *supra*.

To be sure, each step taken, if viewed separately, constituted a normal business activity, similar to many real and substantial transactions consummated on any given business day. But we may not thus fragmentize the transactions here under consideration and view each step thereof as though independent of those which went before and those which followed.

On any normal day of business some persons will buy and others will sell securities. Persons will borrow to effect purchases, and dealers and brokers will hold securities as collateral and, when necessary, borrow securities so held to cover short sales. Lending institutions normally lend many times their actual capital.

But these observations lose significance in the context of the transactions now before us. The steps taken, each in itself a legitimate commercial operation, were here each mirror images, and add up to zero. The various purchases and sales, each real *without the other*, neutralize one another and fairly shout to the world the essential nullity of what was done. No purchase and no sale is essentially identical with what was done here, i.e., identical and virtually simultaneous purchases and sales. The choice of the more complicated and involved method of doing nothing had no purpose, save the erection of the facade upon which petitioners now seek to rely.

We think appropriate here the following language from the opinion of the Court of Appeals for the First Circuit affirming our decision in *Goodstein, supra*, at page 131:

> "Moreover, we are convinced that following the transactions of October 27, 1952, there existed no indebtedness from the taxpayer to Seaboard. Despite the transitory possession by the Guaranty Trust Company of the Treasury notes for Livingstone's account who was acting as the taxpayer's agent, there was never in substance either a purchase of the notes by the taxpayer or borrowing of the purchase funds from Seaboard. However, it would seem that these transactions did create a legal relationship between the taxpayer and Seaboard, but it was not one of borrower and lender. Rather the net result of these transactions was the exchange of promises of future performances between the taxpayer and Seaboard. The taxpayer promised to pay Seaboard a certain preascertained sum of money on March 15, 1954 or at any time before that date which he may select. Seaboard in return promised to acquire and deliver to the taxpayer on the date so selected $10,000,000 face value of 1⅜% United States Treasury notes maturing on March 15, 1954 with interest accrued from the date of the contract."

Petitioners urge that they had no actual knowledge of the mechanics of the transactions as undertaken by C-F and Gibraltar, and we believe this to be true. We disposed of this point in the *Goodstein* case by the following language at page 1188:

> "We think it obvious from the whole record that all the steps taken were pursuant to a preconceived plan

which lacked substance and which was entered into solely to form the basis for a claimed tax benefit. The actual purchase by Livingstone of $10,000,000 face amount of Treasury notes was consummated only to give color to the transaction, and, as pointed out, these notes were disposed of immediately. We think it apparent that it was the intention of all the three participants that the petitioner would not purchase the Treasury notes, that there would be no actual loan to the petitioner, and that he would not pay any interest. He did not risk any borrowed money. The only amount he actually paid out and risked was the $15,000.

"The petitioner, in an attempt to show that he was not party to a pre-arranged plan, testified that he did not give an order for the sale of the Treasury notes, and that he did not know of the sale at the time it occurred. However, the evidence shows that he did, in preliminary conferences, discuss the proposed transaction with M. Eli Livingstone, including the tax consequences, and that in his note given to Seaboard he authorized Seaboard to use the securities. Accordingly, any action taken must be considered to have been at least with his acquiescence."

In any event, regardless of petitioners' ignorance of the actual steps taken, they may deduct the amounts in question as interest only if they were in fact paid as interest on an existing indebtedness, which they intended in good faith to create. These payments do not fit such description. They were in reality the net consideration paid not for a loan, but for a tax deduction, and so viewed are plainly outside of the statute permitting a deduction for interest paid on

an indebtedness. Cf. *W. Stuart Emmons, supra,* where we said at page 31:

> "In the case at bar we might well paraphrase some of the statements of the Supreme Court in the *Gregory* case. Thus, section 23(b) requires a payment for the use or forbearance of money, and not a payment in pursuance of a plan (the creation of an interest deduction) having no relation to the purported result, the purchase of an annuity. The real payment here was not the alleged interest; it was the net consideration, i.e., the first year's premium plus the advance payment of future premiums plus the purported interest, less the 'cash or loan' value of the policy. And the benefit sought was not an annuity contract, but rather a tax deduction of that part of the gross outlay designated for that purpose as 'interest.' Petitioner did not seek an annuity, and in fact gave up all substantial rights of an annuitant in order to reach his true goal, deductions in an amount large enough to reduce his taxes in a sum greater than the net consideration or cost to him of the entire operation."

Petitioners correctly note that the interest deduction does not require a business or profit motive or purpose. It does, however, require a payment of interest on an existing indebtedness, and the contention thus begs the very point in issue.

Had petitioners in fact borrowed money for a vacation, or for any other purely personal purpose, they would clearly be entitled to a deduction for any interest paid on such loan, and we do not understand respondent to contend

otherwise. We must first, however, determine whether petitioners in fact incurred a bona fide indebtedness regardless of their reasons for doing so. We are forced to conclude in the light of the entire record that they did not.

Petitioners did not purport to borrow funds for personal reasons, but rather in respect of hard-headed commercial transactions for profit. They acted within the formal framework of such premise, and it is in the light of the nature of the transactions as claimed by them that we must determine the reality or lack of it in what they did.

Petitioners here purported to enter into a profit-seeking transaction. Yet under the circumstances, no reasonable chance existed of realizing a profit, apart from the "tax gimmick" feature of the transactions, the very aspect in which they were originally presented to and found acceptable by petitioners. It is for this reason that we conclude that the transactions in question, the reality of which may be sustained only on the theory that they were commercial undertakings for profit, were shams, and must be disregarded for tax purposes. Accordingly, respondent's determination is here sustained. Cf. *L. Lee Slayton*, 34 T. C. — (filed April 7, 1960) [Dec. 24,122].

Petitioners now seek, in the alternative, deductions for their net expenditures as losses under section 23(e)(2) of the Internal Revenue Code of 1939.[1] As authority, they

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[1] SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(e) Losses by Individuals.—In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

* * * * *

(2) if incurred in any transaction entered into for profit, though not connected with the trade or business; * * *

cite the Court of Appeals in the *Goodstein* case, which reversed our decision on this issue.

In *Goodstein* the fourth paragraph of the petition reads in part as follows:

> "c. If the said interest payments are not deductible, the Commissioner erred in failing to allow the sum of $14,722.02 as a loss deduction in the computation of petitioners' taxable income for 1952."

No such provision appears in either of the petitions filed here. The point was first raised in petitioners' supplemental brief. Manifestly, the issue was not properly pleaded, and we may not now consider it.

Respondent's present position with respect to the principal issue is to ignore the disputed transactions entirely for tax purposes, both as to income and expense. For protective purposes, he did not in the notice of deficiency delete from petitioner's income certain items which should be eliminated under his present theory, which we believe sound. Accordingly,

Decisions will be entered under Rule 50.

Opinion on Review

UNITED STATES COURT OF APPEALS

FOR THE NINTH CIRCUIT

No. 17,128 Aug. 28, 1961

ALBERT GORDON MACRAE and SHEILA MACRAE,
Petitioners,

—vs.—

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

On Petition for Review of the Decision of the Tax Court of the United States

Before HAMLEY, JERTBERG and MERRILL, Circuit Judges.
JERTBERG, Circuit Judge.

Before us is a petition for review of a decision of the Tax Court of the United States, reported at 34 T.C. 20. The petitioners are husband and wife who filed joint returns on the cash basis for the taxable years 1952 and 1953. The husband, Albert Gordon MacRae, will hereinafter be called the taxpayer.

The Tax Court sustained the disallowance by the Commissioner of Internal Revenue of amounts paid by taxpayer, claimed by him to represent payments of interest on indebtedness, and hence deductible within the meaning of Section 23 of the Internal Revenue Code of 1939,[1] in the

1 Internal Revenue Code of 1939:

"Sec. 23. Deductions from Gross Income.

"In computing net income there shall be allowed as deductions:

* * * * *

"(b) Interest.—All interest paid or accrued within the taxable year on indebtedness. * * *"

(26 U.S.C. 1952 ed., Sec. 23.)

computation of taxpayer's net income for the years 1952 and 1953.

The Tax Court determined and ordered a deficiency in income tax for the taxable year 1952 in the amount of $23,998.38, and a deficiency for the taxable year 1953 in the sum of $78,584.32, and an addition to tax under Section 294(d)(2) of the Internal Revenue Code of 1939 in the amount of $4,301.14.

The taxpayer urges that the Tax Court erred in holding that the prepayments [claimed by taxpayer to represent payments of interest on indebtedness] on asserted loans for the purchase and carrying of United States Treasury Notes and Federal Land Bank Bonds did not represent "interest • • • on indebtedness," and hence were not deductible. In the alternative, the taxpayer contends that the Tax Court erred in not allowing his out-of-pocket costs as an ordinary loss in a transaction entered into for profit under Section 23(e)(2),[2] or as a capital loss under Section 117(g)(2)[3] of the Internal Revenue Code of 1939.

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2 Internal Revenue Code of 1939:

"Sec. 23. Deductions from Gross Income.

"In computing net income there shall be allowed as deductions:

• • • • •

"(e) Losses by Individuals. In the case of an individual, losses sustained during the taxable year and not compensated for by insurance or otherwise—

• • • • •

"(2) if incurred in any transaction entered into for profit though not connected with the trade or business; or • • • "

(26 U.S.C. 1952 ed., Sec. 23.)

3 Internal Revenue Code of 1939:

"Sec. 117. [As amended by Sec. 216 (c), Revenue Act of 1950, c. 994, 64 Stat. 906] Gains and Losses from Short Sales, etc.—

• • • • •

"(g) Gains and Losses from Short Sales, etc. For the purpose of this chapter—

• • • • •

"(2) gains or losses attributable to the failure to exercise privileges or options to buy or sell property shall be considered as short term capital gains or losses; and • • • "

(26 U.S.C. 1952 ed., Sec. 117.)

Opinion on Review

The facts, as stipulated and as found by the Tax Court, are not assailed by the taxpayer. They are reported in 34 T.C. 20. We see no reason for extending this opinion by including them here. In short, the facts reveal a plan devised by a firm of brokers and dealers in securities designed to create sizeable "interest" deductions for high-bracket taxpayers whose principal purpose in agreeing to the plan is to create tax deductions. We recently reviewed a variant of the plan devised by the same firm, in *Kaye* v. *Commissioner of Internal Revenue* (9th Cir. 1961), 287 F. 2d 40, wherein we affirmed the decision of the Tax Court [33 T.C. 511], by relying on the teachings in *Knetsch* v. *United States* (1960), 364 U.S. 361. Variants of a broadly similar plan devised by a Boston broker and dealer in securities were likewise decided against the taxpayers in *Becker* v. *Commissioner of Internal Revenue* (2d Cir. 1960), 277 F. 2d 147; *Lynch* v. *Commissioner of Internal Revenue* (2d Cir. 1959), 273 F. 2d 867; *Goodstein* v. *Commissioner of Internal Revenue* (1st Cir. 1959), 267 F. 2d 127; *Sonnabend et al.* v. *Commissioner of Internal Revenue* (1st Cir. 1959), 267 F. 2d 319; and *Broome* v. *United States* (Court of Claims, 1959), 170 F. 2d 613.

The Tax Court concluded that the transactions set forth in the findings of fact did not give rise to any purchases of Treasury notes or Federal Land Bank bonds for the taxpayer and did not involve any real indebtedness on his part or any payments or receipts of real interest, and that the payments made by taxpayer were in reality consideration for tax deductions, not for loans, hence, not deductible under Section 23(b). In essence, this is the same conclusion reached in the several above cited cases.

Taxpayer contends that the Tax Court erred in reaching such conclusion, and endeavors to distinguish the instant case from the above cited cases, on the ground that the

taxpayer was unaware of the mechanics employed by the lenders to finance the loans made to taxpayer. In brief, neither the taxpayer nor any representative of his was apprised by the lenders of the short selling procedure employed by them, and which were made by the lenders for their own account without collusion on the part of the taxpayer, and thus not attributable to the taxpayer. We find no merit in taxpayer's contention. As stated in *Lynch* v. *Commissioner of Internal Revenue*, *supra*, at page 872:

> "Save in those instances where the statute itself turns on intent, a matter so real as taxation must depend on objective realities, not on the varying subjective beliefs of individual taxpayers. Beyond this, it would strain credulity to the breaking point to suppose that taxpayers had no inkling that something highly unusual was going on."

In any event, regardless of taxpayer's contention, deductions of payments made as interest may be deducted only if they are in fact paid as interest on an existing indebtedness. We agree with the reasoning and the result reached by the Tax Court under the facts of this case.

Taxpayer's alternative contentions relate only to a claimed loss deduction in the taxable year of 1953 for his out-of-pocket costs in connection with the transactions above mentioned. Two different theories under which taxpayer claims to be entitled to deduct these out-of-pocket expenses are advanced. First, taxpayer argues that the deduction is authorized under Section 23(e)(2), *supra;* second, that the loss was attributable to his failure to exercise privileges or options to buy or sell property within the meaning of Section 117(g)(2), *supra*.

The Commissioner contends that we should not consider on this appeal such alternate grounds because they were

not raised in the pleadings before the Tax Court. Taxpayer attempted to raise the ground under the first theory by supplemental motion to the Tax Court after the hearings before the Tax Court had been concluded but before the announcement of decision. We recognize the general rule that new issues may not be raised after the hearing by the Tax Court in the absence of good reason therefor. *Vogel's Estate* v. *Commissioner of Internal Revenue* (9th Cir., 1960), 278 F. 2d 548. On this subject see *Hormel* v. *Helvering* (1941), 312 U.S. 552. In that case the Court stated, at page 557:

> "There may always be exceptional cases or particular circumstances which will prompt a reviewing or appellate court, where injustice might otherwise result, to consider questions of law which were neither pressed nor passed upon by the court or administrative agency below. See *Blair* v. *Oesterlein Machine Co.*, 275 U.S. 220, 225."

We think this case fits this exception. The claimed deduction for out-of-pocket losses arises out of the same transactions which were considered by the Tax Court. No new fact issues are presented, and it is not necessary to go beyond the findings of the Tax Court to consider the propriety of the claimed deduction. The Commissioner is not prejudiced, nor has he been denied the opportunity to present arguments against allowance thereof. Under these circumstances, we believe that justice requires that we pass upon the merits of taxpayer's contentions.

In our view, these out-of-pocket losses are not properly deductible under Section 23(e)(2). To allow such out-of-pocket expenditure as a loss incurred in a transaction entered into for profit would be inconsistent with our affirmance of the Tax Court holding that the transactions here

involved were not in substance purchases of securities with borrowed money entered into for profit, but were in reality attempts to simulate such security transactions for the purpose of artificially creating tax deductions.

While the transactions here involved created no "indebtedness" recognizable under Section 23(b), we are aware of the fact that various legal rights and obligations were created. Courts dealing with variants of the plan involved in the present case were also aware of the creation of such legal rights and obligations. Thus in *Goodstein* v. *Commissioner of Internal Revenue*, *supra*, the court stated:

> "However, it cannot be denied that this amount was actually expended by the taxpayer in connection with a transaction which, although it did not result in the purchase of Treasury notes or the borrowing of money, did create a bilateral contract between himself and Seaboard [the lender]." 267 F. 2d, p. 132.

And in *Lynch* v. *Commissioner of Internal Revenue*, *supra*, the court stated at page 870:

> "When the week's work was completed, what was left was this: Each taxpayer was out of pocket in the sum of $29,114.61, the excess of the alleged prepayment of $117,677.11 'interest,' item (4), over the repayment of $88,562.50 by which the 'loan' exceeded the purchase price of the Notes, item (7). Each taxpayer had a contractual right to require Gail [the lender] to deliver the $650,000 of Treasury Notes described in item (2) against payment of $653,250, with a further right to anticipate payment on the terms stated in item (3). In other words taxpayers for their payment of $29,114.61 had obtained a call on Gail for these Notes. * * *"

Thus, in *Becker* v. *Commissioner of Internal Revenue* (2d Cir., 1960), 277 F. 2d 146, it was held that out-of-pocket losses of the taxpayer in a transaction similar to the one here involved clearly fitted the language of Section 117(g)(2) in that they came about from the failure of taxpayer to call in Notes from the lender and cancel the indebtedness. We agree with the court in *Becker* that out-of-pocket losses are clearly "attributable to the failure to exercise privileges or options to buy or sell property", within the meaning of Section 117(g)(2).

In our view, taxpayer is entitled to claim a deduction for out-of-pocket losses in relation to transactions which were terminated in the taxable year 1953. Since the Tax Court did not purport to determine the amount of such out-of-pocket disbursements, taxpayer's petition to review is granted to the limited extent of remanding the case to the Tax Court for a redetermination of deficiency for the taxable year 1953 in the light of this opinion.

(Endorsed) Opinion Filed Aug. 28, 1961.

FRANK H. SCHMID, Clerk.

Opinion in *L. Lee Stanton and Helen La Fetra Stanton* v. *Commissioner*

FINDINGS OF FACT AND MAJORITY OPINION

Docket No. 68914. 34 TC —, No. 1. Filed April 7, 1960.

Hugh Satterlee, Esq., 30 Broad Street, New York, N. Y., and Rollin Browne, Esq., for the petitioners. Emil Sebetic, Esq., for the respondent.

The Commissioner determined income tax deficiencies against the petitioners of $117,054.16 for 1952 and $232,678.86 for 1953. The principal issues for decision are whether the Commissioner erred in disallowing deductions for each year for interest paid on indebtedness and whether interest income was received when noninterest bearing notes were sold. Alternative errors were alleged.

Findings of Fact

The petitioners, husband and wife, filed their income tax returns for 1952 and 1953 with the director for the second district of New York. They kept their books and filed their returns on a calendar year cash basis.

Lee has been a member of the New York Stock Exchange for 36 years and is a partner in the brokerage firm of Carlisle & Jacquelin. He reported "Adjusted Gross Income" of $254,507.79 for 1952 and of $376,281.30 for 1953. His income, at least since 1950, has been subject to very high tax rates. He took this into account in making his personal investments and sought transactions which would give him the greatest net income after taxes. One such type investment was the purchase of large amounts of short-term Government notes or commercial paper at a substantial discount, financing the purchase through ordinary bank loans secured by the purchased notes and selling them at a profit before maturity but after holding them six months. The excess of the amount realized over cost would be reported as a long-term capital gain and the interest on the

borrowed funds would be claimed as a deduction. The net interest received on the obligations would be taxable as ordinary income. The excess of the interest paid on the borrowed funds over the interest, if any, on the obligations would thus be offset in whole or in part by capital gain and in any event there would be a tax benefit because the interest deduction would wipe out high rate taxable income and the capital gain would be taxed at only 25 per cent.

Lee purchased $9,000,000 principal amount of noninterest bearing financial notes of Commercial Investment Trust, Inc. at market from Salomon Bros. & Hutzler as shown in the following table:

Purchase Date	*Prin. Amt.*	*Price Paid*	*Maturity*
12/11/52	$2,000,000.00	$1,974,750.00	7/ 1/53
12/11/52	3,000,000.00	2,962,312.50	6/30/53
12/11/52	1,000,000.00	987,312.50	7/ 2/53
12/16/52	3,000,000.00	2,964,562.50	6/23/53
		$8,888,937.50	

Lee borrowed money from three New York banks and gave his own 3 per cent promissory notes in the full amounts as security for the loans. Three per cent was the current rate on such loans. The following table shows the dates of the loans and personal notes, the amounts of each, the maturity and the lender:

Date	*Amount*	*Maturity*	*Lender*
12 11 52	$1,974,750.00	6/25/53	Hanover Bank
12/11/52	2,962,300.00	6/25/53	Hanover Bank
12 11 52	987,312.50	7/ 2/53	Marine Midland
12 16 52	2,964,562.50	6/23/53	Guaranty Trust
	$8,888,925.00		

The C. I. T. notes which Lee purchased were delivered to the banks for Lee's account against payment by the banks for his account of the purchase prices of those notes. The loans were secured solely by the C. I. T. notes and Lee's personal notes.

Lee anticipated that the interest he would have to pay on the loans would exceed the gain he would have on the notes but he would have a net gain after taxes from the transaction.

Lee paid $144,032.37 interest on his four notes to maturity in December 1952, as required by the lenders, and claimed that amount on his 1952 return as a deduction for interest paid. The Commissioner, in determining the deficiency for 1952, disallowed that deduction and merely stated that it was not deductible under section 23 of the Internal Revenue Code of 1939.

Lee sold the $9,000,000 of the C. I. T. notes at market before their maturity, as shown in the following table:

Sale Date	*Prin. Amt.*	*Sale Price*
6/26/53	$2,000,000.00	$1,999,097.22
6/26/53	3,000,000.00	2,998,916.67
6/26/53	1,000,000.00	999,458.33
6/19/53	3,000,000.00	2,998,916.67
		$8,996,388.89

Each lending bank received from the purchaser the sales price of the C. I. T. notes held by it, applied part of it to pay off Lee's notes held by the bank and paid the balance to Lee. Lee paid the Hanover bank in June 1953 additional interest of $411.42 on his promissory notes for the one day past maturity which they were held by that bank, and in

that same month he received $493.66 from Marine Midland Trust and $988.19 from Guaranty Trust, representing refunds or rebates of interest to maturity which he had prepaid on his promissory notes held by those banks for the period from the date of payment of the principal of those notes to the date of maturity of each. The additional interest paid was claimed as a deduction and the refunds reported as income on the petitioners' 1953 return. The Commissioner made no adjustment with respect to those amounts.

The excess of the amount received from the sale over the cost of the C. I. T. notes, was reported on the petitioners' income tax return for 1953 as a long-term capital gain. The Commissioner, in determining the deficiency for 1953, added to the reported income $107,805.94, with the explanation that it was interest income from the C. I. T. notes and was not includible in the sales proceeds of the notes. He eliminated $107,801.73 from long-term gain and showed the transaction to have resulted in a net long-term capital loss of $4.21.

Lee purchased at market $5,000,000 principal amount of U. S. Treasury notes bearing interest at 1½ per cent maturing on March 15, 1955, and having accrued interest thereon at the date of purchase, as shown in the following table:

Date Purchased	Purchased From	Price	Cost	Accrued Interest
6/24/53	J. [illegible] & Co.	[illegible]	[illegible]	$ 1[illegible]53
6/24/53	J. [illegible] & Co.	[illegible]	[illegible]	[illegible]
6/29/53	The Wisconsin Nat. Bank [illegible]	[illegible]	[illegible]	1,[illegible]07.18
6/24/53	J. [illegible] & Co.	[illegible]	[illegible]	[illegible]
6/24/53	[illegible] & Co.	[illegible]	[illegible]	[illegible]
7/1/53	Harris Trust & Sav.	[illegible]	[illegible]	[illegible]
			$5,[illegible]03,906.25	$21,[illegible]11.01

Lee borrowed $5,000,000 from four banks and gave his own 3½ per cent promissory notes in like amounts as security for the loans. The loans were to become due on March 15, 1955. Three and one-half per cent was the current rate on such loans. The following table shows the lender, the dates of the loans and notes and the amounts of each:

Lender	*Date*	*Amount*
Mercantile National Bank of Chicago	6/26/53	$ 800,000
Lakeview Trust & Savings Bank of Chicago	6/29/53	600,000
First Wisconsin National Bank of Milwaukee	6/30/53	2,400,000
	(6/25/53	500,000)
First National Bank of Baltimore	(6/29/53	500,000)
	(7/ 2/53	200,000)

Lee expected that his profit on the sale of the notes would exceed the excess of the interest on his borrowings up to the date of sale over the net interest on the Treasury notes to that same date by a substantial amount.

The Treasury notes which Lee purchased were delivered to the banks for Lee's account against the payment by the banks for his account of the purchase price of those notes. The $56,387.50 excess of the loans over the cost of the Treasury notes was remitted by the banks to Lee. Lee, at the time of giving his promissory notes, paid interest thereon in the total amount of $151,830.77. Coupons on the Treasury notes came due on September 15, 1953. The banks retained the proceeds of those coupons.

Lee sold the $5,000,000 of Treasury notes at market to Wm. E. Pollock & Co., Inc. as shown in the following table:

Sale Date	*Prin. Amount*	*Sale Price*	*Accrued Int.*
2/ 3/54	$ 800,000.00	$ 802,250.00	$ 4,707.18
2/ 3/54	600,000.00	601,687.50	3,530.29
6/25/54	2,400,000.00	2,413,875.00	10,271.74
2/ 3/54	500,000.00		
2/ 3/54	500,000.00	1,203,375.00	7,060.77
2/ 3/54	200,000.00		
		$5,021,187.50	$25,570.08

Lee's promissory notes were paid off from the proceeds of the sales at the time of the sales. Lee paid to each of the lending banks in 1954 as additional interest on his promissory notes the accrued interest which he received upon the sale of his Treasury notes, and he also paid in 1954 to the First Wisconsin National Bank $13,500 as additional interest on his promissory note held by that bank.

Lee was charged interest of $189,330.77 on his promissory notes during 1953 against which was applied $15,855.99, the net interest received by the banks on the Treasury notes so that the net interest charged against Lee, paid by him and claimed as a deduction on his return, all for 1953, was $173,474.78.

Lee was charged interest of $57,070.08 on his promissory notes during 1954 against which was applied $43,570.08 interest received by the banks on the Treasury notes in that year, resulting in net interest of $13,500 charged against Lee in 1954 and paid by him in that year and claimed as a deduction on his return for that year.

The excess of the amount realized from the sale of the Treasury notes over their cost, both amounts exclusive of accrued interest, was reported as a long-term capital gain on the petitioners' 1954 return.

The Commissioner, in determining the deficiency for 1953, added $15,855.99 to the reported income with the explanation that it was interest income from the 1½ per cent Treasury notes and disallowed the deduction of $173,474.78 taken for interest paid, merely stating that it was not deductible under the provisions of section 23 of the Internal Revenue Code of 1939.

Lee expected at the time he entered into the Treasury notes transactions that the lending banks would terminate the loans when he chose to sell the Treasury notes and refund to him all unearned interest which they had received on those loans. He had no agreement either with the New York banks which had loaned to him almost $9,000,000 in December 1952 or with the out-of-town banks which loaned him $5,000,000 in the middle of 1953, but the two New York banks had refunded the unearned interest at the time the notes were sold and Lee thought that the out-of-town banks would follow the same practice. However, the out-of-town banks refused to cancel the loans and refund the unearned interest when Lee sought to sell the Treasury notes. He delayed the sales until he negotiated with the banks. He reached compromise agreements with three of them and sold the notes held by them on February 3, 1954. Negotiations with the Milwaukee bank continued, and it was not until June 25, 1954, that they were concluded and the notes sold.

The difference between the quoted bid and offered prices of the Treasury notes at all times material hereto was generally 2 32 but occasionally it was only 1 32. The quoted bid price decline from 98 24 32 on March 16, 1953, to 97 31 32 on June 1, 1953. It gradually rose to 98 14 32 on June 22, 1953, was 98 12 32 on June 29, 1953, and rose

for the first time above par, to 100 1 32 on January 18, 1954. It was 100 9 32 on February 1, 1954, and thereafter generally rose, reaching a high of 100 20 32 on May 3, 1954, after which it fluctuated between 100 19 32 and 100 17 32 until about August 1954, when it started to decline and reached 100 4 32 on December 20, 1954, after which it gradually declined to par in February 1955 and remained there until the maturity date.

Lee would have had a long-term capital gain of $92,093.75 if he had been able to sell all of his $5,000,000 U. S. Treasury notes on February 3, 1954. The excess of the 3½ per cent interest on his loans up to that time over the net interest which he would have received on the Treasury notes up to that date would have been $60,910.47. His capital gain would thus have exceeded net interest by $31,183.28. The action of the banks in refusing to terminate Lee's loans on February 3, 1954, required him to pay to those banks $125,999.69 in excess of the amount which he otherwise would have had to pay. He could find no use for the borrowed money after the sale of the Treasury notes and had none in mind when he borrowed the money.

All stipulated facts are incorporated herein by this reference.

Opinion

Murdock, *Judge*: Lee sold the U. S. T. notes in 1953 and reported for that year on that transaction a long-term capital gain. The Commissioner, in determining the deficiency for that year, taxed the gain as interest instead of allowing it to be included in the sales proceeds of the notes for tax purposes. He eliminated the gain as a long-term capital gain. The Commissioner's action is supported by

the decision of this Court in *F. Rodney Paine*, 23 T. C. 391 [Dec. 20,679]. Cf. *Charles T. Fisher*, 19 T. C. 384 [Dec. 19,335], affd. 209 F. 2d 513 [54-1 USTC ¶9212], certiorari denied 347 U. S. 1014, and *Arnfeld* v. *United States*, 163 F. Supp. 865 [58-2 USTC ¶9692]. The *Paine* case was reversed by the Court of Appeals for the Eighth Circuit, one Judge dissenting, see 236 F. 2d 398 [56-2 USTC ¶9749], but the grounds on which it was reversed are not present in this case.

The petitioners argue that our decision in *George Peck Caulkins*, 1 T. C. 656 [Dec. 13,000] affd. 144 F. 2d 482 [44-2 USTC ¶9416], is in direct conflict with our decision in the *Paine* case, but this Court in the *Paine* case explained how the two are distinguishable. The grounds given there for distinguishing the *Paine* and *Caulkins* cases would likewise apply to distinguish the present case from the *Caulkins* case. Cf. *Commissioner* v. *Morgan*, —— F. 2d —— (12-11-59) [60-1 USTC ¶9141], reversing 30 T. C. 881 [Dec. 23,086]. The Commissioner's determination on this issue has not been shown to have been in error.

The only other issue that need be decided is whether the Commissioner erred in disallowing deductions for 1952 and 1953 for interest paid in those years on indebtedness. Section 23(b) of the Internal Revenue Code, applicable to all years involved herein, provides that in computing net income there shall be allowed as a deduction

> "All interest paid * * * within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter."

No contention is made or could be made that the exception quoted above applies here, nor does section 24(a)(6) apply. Those are the only exceptions to the general rule allowing the deduction of "all interest paid * * * on indebtedness." Congress having enacted the only exceptions it desired to make, the maxim of interpretation, "Inclusio unius est exclusio alterius" applies, i.e., Congress intended no other exception or limitation on the deductibility of interest on indebtedness. All interest paid within the taxable year on genuine indebtedness of any other kind thus entitles a cash basis taxpayer to a deduction of the amount of interest paid. The Commissioner here concedes, as he must, "the reality and validity of the series of transactions." Thus the payments of principal and interest were enforceable. Cf. *W. S. Gilman*, 18 B. T. A. 1277 [Dec. 5856], affd. 53 F. 2d 47 [2 USTC ¶801]; *William Park*, 38 B. T. A. 1118 [Dec. 10,493], affd. 113 F. 2d 352 [40-2 USTC ¶9557]. Congress has indicated that this deduction is not dependent in any other way upon the purpose or motive of the borrower, or the use made of the borrowed funds. Lee borrowed the money here involved for a purpose not prohibited by any provision of the Code and is entitled to the deductions claimed.

$56,387.50 of the borrowed money was not used to buy the Treasury notes. Actually, Lee did not use the rest of it for any evil, immoral or illegal purpose, if that makes any difference. Congress has included no requirement in the Code that the borrowed money be used in connection with a transaction entered into for profit or that it cannot be borrowed for personal or nonbusiness purposes or used in a transaction involving tax benefits, cf. *Commissioner* v. *Park*, 113 F. 2d 352 [40-2 USTC ¶9557], and the Tax Court has no authority to write or read such requirements into the law.

The legislative history of section 23(b) shows that Congress has repeatedly considered and ultimately rejected limitations somewhat comparable to the one now urged by the Commissioner. The House, for example, proposed to restrict the interest deduction in the 1924 Act to interest paid or incurred in carrying on a trade or business and other interest which, when added to nonbusiness losses, exceeded tax-exempt interest received. The Senate struck this out and inserted a limitation on indebtedness incurred or continued for the purpose of evading the payment of taxes when the purchaser carried tax-exempt securities other than certain U. S. obligations. But the reference to "indebtedness incurred or continued for the purpose of evading the payment of taxes" was stricken out in conference. The House proposed another limitation for the 1926 Act, but again the Senate refused and the House concurred. The 1932 Act broadened the restriction to deny deduction for interest on indebtedness incurred or continued in connection with the purchasing or carrying of an annuity. The House proposed to broaden the restriction in the 1934 Act, but the Senate refused and also struck out all reference to annuities. The House at the same time proposed in section 24(a)(5) to disallow any deduction allocable to any class of income wholly exempt from tax, but the Senate amended to preclude the application of this provision to the deduction for interest and the House accepted the amendment. See also Revenue Act 1921, section 206(a)(3) and (4), and Revenue Act 1924, section 208(a)(3), (5) and (6), which imposed certain restrictions afterwards dropped from the law and never re-enacted. Cf. section 24(a)(5) and (6) of the 1939 Code.

The Internal Revenue Code imposed heavy taxes upon Lee and he sought a legal way within the provisions of the Code to make a profit for himself after taxes, the only

kind of profit which can do any taxpayer any good. His Treasury note transactions would have been profitable before taxes, if events had happened as he anticipated they would at the time of entering into the transactions. He had reasons, which seemed sufficient to him at the time, to believe that the out-of-town banks would allow him to terminate his loans with the return to him by the banks of the unearned interest at any time he chose to sell the Treasury notes and pay off his bank loans, as the New York banks had done. A deduction for the actual interest which he paid over the term of the loans could not have been denied to him, if that had happened. The taxability of the excess of the amount realized from the sale of the Treasury notes in 1954 over their cost is not an issue in this case, but it was a transaction entered into for profit, and which resulted in a profit, if that is material here. What reason is there for penalizing Lee and deviating from the plain words of the Internal Revenue Code merely because the unexpected action of the banks wiped out Lee's real gain by requiring him to pay about $126,000 of additional interest?

All of Lee's borrowings involved herein were genuine and resulted in real indebtedness within the meaning of section 23(b). There was no collusion. The lenders actually advanced the money borrowed for Lee's use. The money was used in the outright purchase of securities at market. The securities became the property of Lee. They were held as security by the lenders of the money. Lee had all the benefits and risks of ownership. All dealings were "at arm's length." Once he entered into the transactions he was required to do all that he did do, and no step which he took was lacking in substance or legal effect. He was strictly within the law at all times, and the interest deductions which he took for 1952 and 1953 were in exact accordance

with the express provisions of section 23(b). The Commissioner concedes all of this. How then does the Commissioner attempt to justify his disregard of the plain provisions of the Internal Revenue Code whereby he taxes interest received and capital gains on the transactions but denies deductions for all interest paid? He says:

> "This Court has already approved determinations of respondent comparable to the one at issue herein. Cf. *Eli D. Goodstein* (1958) 30 T. C. [1178], No. 124 [Dec. 23,152], aff'd (CA-1, 1959) —— F. 2d —— [59-1 USTC ¶9474], 3 A. F. T. R. 2d 1500; *Abraham M. Sonnabend*, T. C. Memo. 1958-178 [Dec. 23,183(M)], aff'd per curiam (CA-1, 1959) —— F. 2d —— [59-1 USTC ¶9475], 3 A. F. T. R. 2d 1505; *John Fox*, T. C. Memo. 1958-205 [Dec. 23,270(M)]; *Matthew M. Becker*, T. C. Memo. 1959-19 [Dec. 23,441(M)]; *George G. Lynch* (1959) 31 T. C. [990], No. 98 [Dec. 23,456] (On appeal); *Leslie Julian* (1959) 31 T. C. [998], No. 99 [Dec. 23,457] (On appeal); *Egbert J. Miles* (1959) 31 T. C. [1001], No. 100 [Dec. 23,458] (On appeal); See also *W. Stuart Emmons* (1958) 31 T. C. [26], No. 4 [Dec. 23,201] (On appeal [59-2 USTC ¶9667]). Respondent submits that the principles applied in the above decisions are controlling and dispositive of the case at bar.
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> "In the light of the foregoing discussion, respondent submits that as a matter of substantial commercial reality, Stanton did not purchase any CIT Notes and Treasury Notes, incur any indebtedness, pay any interest, or sell any CIT Notes and Treasury Notes, which were significant or recognizable for tax purposes. *George G. Lynch, supra; Egbert J. Miles, supra; W. Stuart Emmons, supra.*"

The facts in each of the cited cases distinguish it from the present case. The *Emmons* case bears no resemblance to the facts here. The leading case cited is *Goodstein*, but important differences rob it of all effect as an authority here. The alleged *Goodstein* transactions were collusive shams throughout arranged by Eli Livingstone.[1] The Treasury notes were "purchased" and "sold" practically as one transaction in which no real money passed on behalf of the taxpayer. The alleged lender corporation had no money to lend. No Treasury notes were held as security or otherwise by that corporation. Goodstein was not the owner of any Treasury notes during the time the "loan" was supposed to be in effect. He was not entitled to receive and did not receive the benefit of any interest on Treasury notes. There was no indebtedness of $10,000,000. The whole matter of "interest" was merely an empty bookkeeping device to create the illusion of indebtedness, interest and long-term capital gain. However, the Court in affirming the *Goodstein* case, 267 F. 2d 127 [59-1 USTC ¶9474], expressed the thought that Goodstein, despite the recognized shams, might be entitled to a deduction for some loss in a later year not before the Court. See also *Lynch* v. *Commissioner*, —— F. 2d —— (12-17-59) [60-1 USTC ¶9161], affirming the *Lynch* and *Julian* cases, *supra*, both of which involved similar shams arranged by Livingstone.

The Commissioner quotes language from the Tax Court opinion in the *Miles* case to the effect that "if petitioner did purchase the bonds and incur an indebtedness he did so but for one reason, to realize a tax deduction" and that being so, the interest was not deductible within the intend-

1 Statements in dissents hereto that Livingstone had something to do with this case are improper inferences from Stanton's testimony which I alone heard.

ment of section 23(b). That part of the opinion was not necessary in denying the deduction since the facts disclosed a repetition of the collusive shams in the *Goodstein* case. The Court of Appeals for the Second Circuit, in affirming the *Lynch* and *Julian* cases, did not rely on any such reasoning and did not rely upon *Gregory* v. *Helvering*, 293 U. S. 465 [35-1 USTC ¶9043], which, it said, "the government construes as establishing a doctrine forbidding generally the recognition for tax purposes of transactions entered into for the sole purpose of tax avoidance." It relied instead "on the more fundamental ground" that there was no genuine indebtedness. The *Goodstein*, *Julian*, *Lynch* and *Miles* cases were all correctly decided on the "fundamental ground" that there was no real indebtedness in any of them but merely collusive shams to create a supposed appearance of indebtedness on which supposed interest was paid. Anything contrary to the holding here was not necessary in the *Lynch*, *Julian* and *Miles* cases and is not binding in this case although those cases and the *Goodstein* case were correctly decided on their own facts.

Knetsch v. *United States*, 272 F. 2d 200 [59-2 USTC ¶9767], certiorari granted —— U. S. ——, (2-23-60), decided by the Court of Appeals for the Ninth Circuit, involved a transaction in which the taxpayer purchased 2½ per cent annuity savings bonds from a life insurance company by borrowing the necessary money from the life insurance company at 3½ per cent. The Court affirmed the judgment of the District Court which had held that the amount paid to the insurance company was not interest in fact but the purchase price of a tax deduction. The Court of Appeals said it agreed with the opinion in *Weller* v. *Commissioner*, 270 F. 2d 294 [59-2 USTC ¶9667]. The *Weller* case affirmed 31 T. C. 33 [Dec. 23,202] and also affirmed *W.*

Stuart Emmons, supra. The taxpayers in the *Emmons* and *Weller* cases had purchased annuity contracts and borrowed money from banks to prepay at a discount all future premiums and then received the loan value which the contract would have accumulated up to the time the prepaid premiums would be due. They then used a part of this money to pay off the loans at the banks. *The interest on the bank loans was not in controversy.* The taxpayers were disallowed claimed deductions for "interest" on the amounts they allegedly borrowed from the insurance companies, since no money was in effect loaned to them by the insurance companies. The Court of Appeals for the Fifth Circuit in *United States v. Bond*, 258 F. 2d 577 [58-2 ustc ¶9716], in a situation similar to that involved in the *Knetsch* case, held that the interest on the borrowing from the insurance company was deductible. The payments involved in all of the above four cases were on alleged loans from the insurance companies so that the whole transaction in each case was between the taxpayer and the insurance company. No genuine indebtedness existed on which interest was paid. Such cases are distinguishable factually from the present case. The present taxpayer bought securities on the open market and borrowed money from banks without any collusion to avoid income taxes between him and any person with whom he dealt. His indebtedness was genuine and section 23(b) allows a deduction for interest paid on such indebtedness.

Reviewed by the Court.

Decision will be entered under Rule 50.

(Dissenting opinions are not reprinted)